P.2018/130

THE STATES OF DELIBERATION
of the
ISLAND OF GUERNSEY

STATES' TRADING SUPERVISORY BOARD

AURIGNY AIR SERVICES – AIRCRAFT ACQUISITIONS

The States are asked to decide:-

Whether, after consideration of the policy letter entitled 'Aurigny Air Services – Aircraft Acquisitions', they are of the opinion:-

(i) To note the decision of the States' Trading Supervisory Board to approve Aurigny Air Services' business case for the replacement of its existing three ATR72-500 aircraft with ATR72-600 aircraft, subject to the considerations set out in section 5.7.2 of the policy letter;

(ii) To direct the Policy & Resources Committee to enable the replacement of Aurigny Air Services Limited's existing three ATR72-500 aircraft with ATR72-600 aircraft by providing:

(a) The necessary guarantees for borrowing from third parties, including the application of a guarantee fee not exceeding 0.8%, or a loan from the proceeds of the States of Guernsey bond issue; and,
(b) Guarantees that may be necessary to enable Aurigny Air Services to enter into such interest rate and/or currency exchange rate swap agreements that may be required,

in accordance with the considerations set out in section 5.4 of the policy letter.

The above Propositions have been submitted to Her Majesty's Procureur for advice on any legal or constitutional implications in accordance with Rule 4(1) of the Rules of Procedure of the States of Deliberation and their Committees.

<u>THE STATES OF DELIBERATION</u>
<u>of the</u>
<u>ISLAND OF GUERNSEY</u>

STATES' TRADING SUPERVISORY BOARD

AURIGNY AIR SERVICES – AIRCRAFT ACQUISITIONS

The Presiding Officer
States of Guernsey
Royal Court House
St Peter Port

9th November, 2018

Dear Sir

1 Executive Summary

1.1 Following a review of both its future operating model and fleet requirements, Aurigny Air Services Ltd (Aurigny) has developed a business case to replace its existing three ATR72 series-500 aircraft. This proposes that its three existing aircraft, two of which are owned and one of which is leased by Aurigny, should be replaced with the series-600 version of the same aircraft. The business case for the acquisitions addresses the business requirement to replace assets of this nature as they age, as well as broader commercial opportunities that they will provide for both the airline and the wider community.

1.2 Under the terms of its Memorandum of Understanding with the States, Aurigny has to seek the approval of the States' Trading Supervisory Board (STSB) for any investments or divestments greater than £500,000, including the purchase of new and/or sale of existing aircraft. The STSB has appointed an independent aviation consultant, PA Nyras, to provide it with the necessary assurance on the proposals developed by the airline. It has also considered the business case within the context of both: the Strategic Review of the airline previously commissioned by the Policy & Resources Committee (P&RC), which included an objective for the airline to reach a break-even position; and, the recent changes agreed by the States to its Air Transport Licensing Policy Statement.

1.3 In part, the replacements are being driven by the age of the aircraft. As such, they can be considered as a routine requirement for the airline as it seeks to improve both its service reliability and financial performance. However, in this case, they will also offer a range of additional benefits, including: equipping the aircraft with an enhanced flight vision system (EVS) known as ClearVision to reduce disruption in foggy weather conditions (subject to its certification)[1]; an improved passenger experience, including the ability to accommodate more "carry-on" baggage in the aircraft cabin; and, an opportunity to consider adjusting the airline's livery in a much more cost-effective manner than might otherwise be the case in order to promote Guernsey more strongly and visibly.

1.4 The business case, which has now been approved by the STSB by a majority following an external assurance process, has concluded that the net improvement in Aurigny's forecast profit and loss (P&L) performance over the next 10 years arising from the replacement of the aircraft would be £4.1m. The main movements within the above P&L performance are as follows:

- A net benefit (after accounting for additional ownership and other transition/associated costs of acquiring a new fleet) of £5.2m from reduced maintenance costs and reductions in delay and disruption costs associated with the operation of a younger and, therefore, more reliable fleet;

- A benefit of £1.1m in reduced delay and disruption costs arising from the installation of an enhanced flight vision system on the aircraft, improving their ability to operate in foggy weather conditions;

- A new cost of £2.2m arising from the application of a fee that the P&RC has indicated it will apply in accordance with its established policy of up to 0.8% for a States of Guernsey guarantee that is required to secure a private loan to fund the acquisition of the aircraft.

It should be stressed that the improvement in the P&L position is measured against a future baseline case that assumes that the existing ATR fleet is retained. All other things being equal, if the existing fleet was retained, then Aurigny's future P&L performance will deteriorate as a result of operating ageing aircraft. The proposed replacement safeguards against this prospect, rather than addressing Aurigny's current P&L position.

1.5 Aurigny has evaluated different options for acquiring the aircraft, including leasing or purchasing them. The business case demonstrates that purchase of the aircraft is the better and most cost effective option. It is intended that the purchase will be financed by a long term fixed rate loan from a locally based private bank for a total sum of approximately US$60m (the final loan value will be dependent on the exchange rate applicable at the time of the acquisition and the proceeds from the sale of two of Aurigny's existing ATR aircraft). The rates of interest currently on offer are cheaper than those available through the States of Guernsey bond proceeds, even after application of the aforementioned guarantee fee.

[1] ATR is targeting certification of the ClearVision system in March/April 2019

1.6 As such, there is no requirement for the States to provide capital funding for the acquisition. As the proposed loan is subject to the provision of a States' guarantee, this policy letter seeks to provide the Policy & Resources Committee (P&RC) with the authority to provide such a guarantee. As such, it is consistent with the process previously adopted by the States when considering the acquisition of aircraft by Aurigny[2]. However, in the event that there is an adverse movement in the interest rate available before Aurigny is able to fix it in accordance with the offer currently available, this policy letter also seeks to provide P&RC with the authority to provide Aurigny with a loan from the bond proceeds. Use of the bond would only be more cost effective if there was a movement in the base interest rate in excess of 1%.

1.7 In approving the business case, the STSB has taken note of the results of the external assurance process undertaken by PA Nyras and, in particular, its observations as follows:

- It supports the business case's overall recommendation to replace the existing ATR fleet;

- The terms offered by ATR for both the sale of new aircraft to Aurigny and the purchase back of two of its existing aircraft represent a good offer in the current market;

- Ownership of new aircraft, rather than leasing, allows Aurigny greater flexibility to address any future changes in the market environment. The impact of any such changes should not be materially different for Aurigny whether it orders new aircraft or continues operating its existing fleet;

- Given the financing terms available, the optimal approach is to acquire, rather than lease, the aircraft; and;

- It would not recommend deferring the replacement until a later date.

Having completed their review, PA Nyras confirmed that it supported the recommendations put forward by Aurigny in its business case for the replacement of the aircraft.

[2] Resolutions 1 and 2 of Article X of Billet d'Etat XVI of 2007; Resolutions 1and 2 of Billet d'Etat XVII of 2013; and, Resolution 1 of Article XI of Billet d'Etat X of 2014

2. Aurigny – Fleet Review

2.1 Current Fleet

2.1.1 Aurigny currently operates a fleet of nine aircraft, some of which are leased, but the majority of which are owned. The aircraft break down into three broad categories: its Embraer 195 jet, which is dedicated to the airline's lifeline service between Guernsey and London Gatwick; its ATR turboprops, which also operate two of the daily London Gatwick services and fly to a number of other regional points within the UK, as well as providing some general back-up capacity; and, its Dornier fleet, which operates services between Alderney, Guernsey and Southampton. Within both the ATR and Dornier fleets, there are two sub-variants. A full schedule of the existing fleet is attached as Appendix I to this policy letter.

2.1.2 Under the terms of Aurigny's Memorandum of Understanding (MoU) with the States, aircraft acquisitions and disposals of more than £500,000 require the approval of the STSB. Historically, the States have agreed that Aurigny's aircraft acquisitions should be funded through borrowing, either from the private sector or, more recently, from the proceeds of the States of Guernsey bond issue. In cases where private loan facilities have been used, the States have previously agreed[3] to provide guarantees for those loans.

2.1.3 In early 2018, Aurigny completed a comprehensive review of its current and future fleet requirements. This was carried out within the context of the publication in 2017 of the P&RC recommendations in response to the Strategic Review of the airline that it had commissioned. Importantly, it was also carried out before the Committee *for* Economic Development had published its policy letter[4] on its review of the Air Transport Licensing (ATL) policy statement. The implications of the new ATL policy statement for Aurigny's future business model are considered later in this policy letter.

2.2 Fleet Review – Scope and Context

2.2.1 The fleet review encompassed a wide range of options, variables and factors, including the following:

- Opportunities to optimise the airline's cost base and contribute towards the achievement of a break-even position;
- Benefits arising from a reduction in the fleet's complexity;

[3] Resolutions 1 and 2 of Article X of Billet d'Etat XVI of 2007; Resolutions 1and 2 of Billet d'Etat XVII of 2013; and, Resolution 1 of Article XI of Billet d'Etat X of 2014
[4] Article 5 of Billet d'Etat XIX of 2018 – Review of Air Transport Licensing

- Opportunities that emerging cockpit based Enhanced Vision Systems offer to reduce delays and cancellations as a result of fog and reduced visibility;

- Examination of alternative jet and turboprop aircraft options for the operation of the airline's lifeline services to/from London Gatwick;

- The fleet planning challenges presented by the operation of services to three distinctly different markets, these being: its London Gatwick services; its services linking Alderney with Guernsey and Southampton; and, its regional services to a number of points within the UK;

- Substitution and/or replacement of its existing ATR turboprop aircraft with alternative models of turboprop and/or alternative regional jets;

- The peak and off-peak scheduling and capacity requirements for its services, coupled with the implications that take-off and landing slot-constraints at London Gatwick can have;

- The need to provide some spare resilience within the fleet to provide cover for planned aircraft maintenance and to recover operations following any periods of either weather or technical disruptions; and,

- The need to maintain the Dornier fleet, pending the outcome of a Public Service Obligation (PSO) tendering process for the operation in future of services to and from Alderney.

2.2.2 The review of the fleet was carried out within the context of a number of adjustments to Aurigny's route mix or "mission" agreed with the STSB in 2017 in response to the aforementioned Strategic Review in order to reduce the Company's losses. In summary, these were as follows:

- The withdrawal of its significantly loss-making London City services at the end of October 2017. Whilst the withdrawal of this service was a difficult decision, there has been only a small reduction of circa 2½% in Aurigny's overall London passenger traffic[5], suggesting that the majority of passengers that previously used the City service have migrated back to either its Stansted or Gatwick operations or alternative services at Southampton;

- Some rationalisation and adjustments to the capacity and schedules on its remaining UK regional services[6], all of which have continued to be served;

[5] Source: Civil Aviation Authority – Monthly Airport Data: November '17 – July '18.
[6] Manchester; London Stansted; Bristol; East Midlands; Leeds Bradford; and, Norwich.

- The withdrawal of its smaller (leased) ATR-42 aircraft from scheduled service and its redeployment on the wet and/or dry sub-lease markets pending its return to the lessor upon the expiry of its lease contract in 2020. This aircraft had previously been acquired on a 5-year lease term, principally for the operation of the London City services. To date, Aurigny has had limited success in marketing this aircraft in these markets, but it would incur significant financial penalties in the event that it was to return the aircraft early to its lessor.

2.2.3 The airline's Board of Directors has advised it is committed to tendering for the operation of the Alderney service(s) under a future PSO arrangement for those routes. Whether Aurigny is successful or not in tendering, this will "relieve" Aurigny's P&L account of the substantial cost of sustaining those services in future. Aurigny's budget for 2019 anticipates a total loss of £4.37m (prior to any adjustments in accordance with Financial Reporting Standard[7] FRS 102). It should be noted that these budgets have been prepared on the assumption that it would continue to operate its Alderney services throughout the year, as there remains uncertainty at this time as to when any new contracts under the forthcoming PSO arrangements for them will commence. Of this £4.37m, it has advised that: its Alderney services will incur a loss of £3.0m; and, interest payments on the overdraft required to fund accumulated and in-year losses (largely arising from the Alderney services) will amount to £0.3m.

2.3 Fleet Review – Conclusions and Assurance

2.3.1 The conclusions of the fleet review were as follows:

- Given the aforementioned route mission agreed with the STSB, there are no viable options to simplify the number of main types operated;

- The current ATR fleet will be simplified when the smaller ATR42 leaves upon its lease expiry in March 2020. There is no need to replace this aircraft;

- Simplifying the fleet by replacing the Embraer jet with additional ATR turboprop aircraft would leave the airline with insufficient capacity to meet the demands of the London Gatwick route. Whilst it would be possible to compensate for this shortfall by operating higher frequency services with these smaller aircraft between Guernsey and London Gatwick, there is little prospect of being able to obtain the requisite number of additional slots at the right times of day to enable it to do so;

[7] FRS 102 is the Financial Reporting Standard applicable in the UK and Republic of Ireland. It is issued by the Financial Reporting Council in respect of its application in the United Kingdom

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- An alternative approach to simplifying the fleet could involve replacing one or more of the ATR aircraft with Embraer jets (available in different variants seating between circa 70 (Embraer E170) and 122 seats (E195). A larger variant of this model would also have the benefit of providing better back-up capacity for Aurigny's existing E195 on the Gatwick route. However, analysis of the different options showed they would produce markedly worse financial results for the company. The operating costs of such jets are much higher due to the aircraft's increased weight, maintenance costs and significantly higher fuel burn;

- Sub-contracting out the operation of the Embraer jet to another operator was unlikely to result in any significant benefits. The STSB has accepted that, in the current market conditions, this would not be an attractive option. It was concerned that this would entail ceding too much control over the operation of the key strategic link to London Gatwick. It would also leave the Island exposed to changes in the business model of the partner airline concerned, which would not necessarily remain aligned to the Island's own interests in future. Whilst still a relatively young aircraft, Aurigny will nevertheless develop a strategy to determine the optimum point for its replacement, taking into account the times of future planned major overhaul events and requirements.

As such, the review's conclusions were that the optimum fleet mix for the time being for the Gatwick and other UK regional services remained the single Embraer jet and three ATR72 aircraft. It should be noted that one of these three ATR aircraft acts as a 'back-up' aircraft for the other ATRs as well as the Embraer jet. The future of the Dornier fleet would be dependent on the outcome of the PSO process for the operation of the Alderney services.

2.3.2 Given the importance of Aurigny's fleet review in setting the context for future aircraft acquisitions and disposals, the STSB commissioned an independent review and verification of its findings. This was undertaken by PA Nyras, an international aviation consultancy. The results of this review can be summarised as follows:

- There is no reduction in fleet complexity (for example by replacing the Embraer 195 jet with ATR turboprops) envisaged for good reasons, given the requirement for Aurigny to provide sufficient capacity to meet the Island's needs on the Gatwick route and within the constraints around slot availability at that Airport;

- The ATR72 is the right type of aircraft in terms of size and operating economics for the demands of the UK regional routes and, in comparison to other turboprop and jet alternatives, is the best option. The same analysis concluded that the Embraer 195 is the right aircraft for the Gatwick service.

Options to wet lease jet aircraft for the Gatwick operation should be kept under review;

- There is a clear requirement for Aurigny to include standby capacity within its fleet. The review highlighted the need for further analysis in this area, which the Board subsequently asked Aurigny to undertake in developing any business case it eventually brought forward for the acquisition of replacement aircraft.

The STSB concluded that the results of the fleet review, together with the assurance provided by PA Nyras, established a sufficient basis for the retention by Aurigny of an ATR fleet (whether old or new), albeit the process did highlight a number of additional more detailed issues for consideration by Aurigny in developing in future a business case for replacement of the existing fleet.

3. Strategic Context

3.1 Shareholder Guidance - Update

3.1.1 The STSB has been conscious that any business case for the replacement of the ATR fleet should be based on shareholder guidance developed within the context of the P&RC's recommendations arising from the Strategic Review of the airline that it commissioned, which were published in 2017, and the new ATL policy statement agreed by the States[8] in 2018.

3.1.2 The recommendations arising from the Strategic Review included the following:

- Aurigny is to be considered and treated as an economic enabler for the Bailiwick through focusing on essential economic enablement routes;

- The STSB should monitor and analyse opportunities for the application of new landing system technologies to improve the ability to land in adverse weather conditions;

- The shareholder objectives for Aurigny should include requirements for it to move to a sustainable operating surplus year-on-year and to increase the number of passengers carried by the airline.

3.1.3 The STSB has carefully considered the implications of the new ATL policy adopted by the States in July of this year and, specifically, its resolutions as follows:

- To note that the Committee *for* Economic Development intended to

[8] Resolution 6 of Article V of Billet d'Etat XIX of 2018 – Review of Air Transport Licensing

designate the Gatwick route as a lifeline route and to agree that there was no need to change the provisions of the policy statement in respect of Gatwick. This position would be reviewed again by the end of 2023;

- After considering an amendment from Deputy Yerby and Deputy Dorey, that the Manchester, Jersey and Southampton routes should not be designated as lifeline routes;

- That operators on routes other than the lifeline ones no longer need to hold air transport licences, effectively moving to an “open skies” position on those routes.

3.1.4 As a result of the above, the STSB has issued the following updated guidance to the airline:

- Aurigny’s role as an economic enabler is principally enshrined in and satisfied by its primary role to operate the Gatwick route and, subject to the outcome of the PSO process, the Alderney route(s);

- Aurigny’s focus must now be on the development of a business plan that takes the airline to a breakeven position. The STSB has accepted that the market conditions within which Aurigny operates are volatile and, as such, has set an objective that requires it to reach a breakeven position on a rolling five-year basis on its Gatwick and other UK regional services;

- The States’ adoption of an open skies policy on all but the Gatwick and Alderney services means that it is looking to the wider airline market, not just Aurigny, to act as an economic enabler. If, in the interests of economic enablement, further market intervention is required in future (whether this be in terms of support for routes, fares and/or schedules available), it will be for the Committee *for* Economic Development to determine and, where necessary recommend to the States, the mechanisms by which such support should be injected into the market and how this will be funded;

- Whilst it may elect to do so, there is no absolute requirement for Aurigny to operate any other routes beyond Gatwick and, pending the outcome of the PSO process, the Alderney route(s). Responsibility for decisions on other routes rests with Aurigny’s Board of Directors, taking into account commercial considerations and the requirement to breakeven;

- Within the context of the above, Aurigny’s purpose is to act as an asset that is used to maintain and improve the Island’s connectivity.

3.2 Aurigny – Future Business Model – Options

3.2.1 At the request of the STSB, Aurigny has therefore undertaken a further review of its business model, including its fleet composition and route mix, which takes into account the principles and guidance set out above. At the outset, it was agreed that this review should exclude the operation of the Alderney service(s), the future of which will be determined separately by the forthcoming PSO process being led by the Committee *for* Economic Development (CfED). As such, the review considered two different scenarios:

- Its current 4 aircraft model, based on the operation of its existing Embraer jet and three existing ATR72 turboprops;

- A new 3 aircraft model, based on the operation its existing Embraer jet, but only two of the ATR72 turboprops. This is the minimum complement of aircraft required to meet the provisions of the Gatwick service.

Both models assumed that the introduction of a PSO framework for the Alderney service(s) meant that the losses Aurigny incurs in their operation will no longer have to be sustained by the airline's P&L account. As such, the Alderney service(s) were discounted from the models. It was also assumed that one of the ATR aircraft included in each model would be retained for back-up purposes to provide an appropriate level of service resilience. Importantly, both models assumed no change in the existing service frequencies to Gatwick, which require up to 4 daily jet rotations and 2 daily turboprop rotations to deliver the level of capacity the route requires within the constraints of the current slot allocation.

3.2.2 From an operational perspective, the 3 aircraft model would result in the withdrawal of Aurigny's regional services to Manchester, Leeds/Bradford, Bristol, East Midlands, Norwich (seasonal) and Grenoble (seasonal winter-ski). Only the services to Gatwick and Stansted would be maintained. Compared to the 4 aircraft model, this would have resulted in an annual reduction in seats offered to the Guernsey market by Aurigny of 180,000 and a forecast reduction in the number of passengers carried by the airline of 115,000 per annum.

3.2.3 From a financial perspective, the 3 aircraft model indicated better performance, anticipating that Aurigny should make profits of between £1m and £2m per annum, whereas the 4 aircraft model indicated a more modest position. In this scenario, it should still be able to reach a break-even position, albeit with profits from its London operations cross-subsidising its other regional services.

3.2.4 Following consultation with both the P&RC and the CfED, the STSB has concluded that the risks to the Island's connectivity associated with a 3 aircraft model are not acceptable. Given its role as a connectivity asset, it agreed that Aurigny should continue to develop its future business plans based on a 4 aircraft model. Given the sensitivity of the airline's performance to even small changes in the external environment (exchange rates, fuel prices etc), it accepts that Aurigny's ability to deliver a breakeven position under a 4 aircraft model is more marginal. However, it has concluded that this model strikes the most appropriate balance between financial performance and maintaining the Island's connectivity. Clearly, it will need to keep this model under review in light of changes in the competitive landscape, decisions about future runway lengths and the time taken to deliver any changes in the airport infrastructure that might be agreed in future.

4. Replacement of the ATR Fleet – Business Requirements

4.1 The three existing ATR72 aircraft operated by Aurigny were manufactured in 2009 and are the older series-500 variant. Two are owned by the airline and one is leased. This variant is no longer in production and has been replaced by the series-600 variant. Aurigny has proposed to the STSB that planning should commence for the replacement of these aircraft in 2019 as they reach 10 years of age with new series-600 variants. At that point in time, the projected book value of the two ATR72 owned by the airline will be £11.38m, with outstanding loans for them projected as £7.7m. The agreement for leased ATR72 ends in November, 2021.

4.2 At an early stage in the business planning process, Aurigny identified a number of business requirements that a replacement programme should seek to satisfy. These included the following:

- Firstly, a need to improve the airline's financial performance in support of the breakeven target established for the airline;

- Secondly, the need to address the operational and financial issues associated with operating ageing aircraft. Whilst the aircraft are at the mid-point of what might normally be expected to be a full economic life of 20 years, maintenance costs are rising. The small scale of Aurigny's fleet means that it has considerably less resilience to deal with technical delays than those airlines operating larger fleets of a similar or older age. Dispatch reliability data provided by the manufacturer for the ATR72 based upon the age of the existing aircraft suggests that the technical delays with the current fleet of series-500s will increase over the planning horizon to double their current levels by 2028. In addition, their age means that scheduled maintenance checks will require each aircraft to be withdrawn for longer, reducing Aurigny's resilience at those times to recover from unplanned disruption elsewhere on its network. Aside from the disruption these factors would cause to passengers, maintenance costs will increase, as will penalty payments of €250 per passenger that are currently payable under existing EU regulations[9] in the event of technical delays exceeding 3 hours for flights departing the UK (not Guernsey);

- Thirdly, the need to reduce weather related delays to flights. The STSB was conscious that the aforementioned Strategic Review of Aurigny included a recommendation that it should monitor and analyse the opportunities for the application of new landing system technologies to improve the ability of aircraft to land in adverse weather conditions. From Aurigny's perspective, the benefits of doing so would include:

  - Reductions in the direct costs associated with delays and disruption (primarily the provision of hotels, meals and ground transportation as well as lost revenue where passengers opt to cancel their booking and not travel at all);
  - The ability to "recover" operations more quickly following periods of fog;
  - A reduction in the need to charter additional aircraft on an ad hoc basis to assist in the recovery effort following fog.

  From a community perspective, better reliability will improve the reputation of Guernsey (and the airline), whilst reducing the knock-on costs to the wider economy (businesses, hotels and so forth) that inevitably arise from delays and cancellations.

- Fourthly, the need to provide capacity within the passenger cabin to accommodate more and larger carry-on bags in the overhead lockers following the introduction of Aurigny's "unbundled" fare structure, which enables passengers to take advantage of cheaper hand-baggage only fares. At the moment, there is an inconsistency in the product Aurigny is able to offer, with the existing ATRs incapable of carrying the same sized carry-on bags as the Embraer. In addition, where flights are particularly busy, there is a risk that passengers have to have their hand-baggage placed in the aircraft hold when the overhead lockers become full;

- Finally, the STSB has concluded that there would be merit in updating Aurigny's aircraft livery with one that promotes "Guernsey" more strongly and visibly. Thus far, there has been a reluctance to do so, given the substantial cost of repainting the existing fleet. However, the acquisition of new aircraft presents an opportunity to apply an updated livery to "factory-

[9] The EU Flight Compensation Regulation 261/2004 establishes rules on compensation and assistance to passengers in the event of denied boarding, flight cancellations or long flight delays. It requires compensation of €250 for flights of up to 1500km that are delayed for over 3 hours.

fresh" aircraft at little additional cost. In terms of its UK operations, this would then just leave the Embraer jet requiring repainting at the next most appropriate point in its maintenance cycle in order to minimise costs. A decision on whether or not to re-paint the Dornier fleet would be made only in conjunction with any future PSO arrangements for the Alderney services.

4.3 Aurigny has undertaken an assessment of alternative makes of turboprop within this class. There is only one other type (the Bombardier Dash 8) with the necessary seating capacity and, whilst this is a faster aircraft, its heavier weight, higher fuel consumption and higher operating costs means that it is not a suitable match for the relatively short sectors that Aurigny operates. There would also be significant transition costs in moving to a different make of aircraft. These conclusions were consistent with the aforementioned results of the fleet review. As a result of all the above, the business case that has been developed by Aurigny for replacing its existing fleet focuses on the extent to which the available ATR options can address the requirements set out above.

5. Acquisition of Replacement Aircraft - Business Case Development

5.1 <u>Introduction</u>

5.1.1 The business case has been prepared in accordance with the 'five-case model' adopted by the States. It assumes a baseline "do-nothing" option where the airline plans to retain the existing series-500 fleet for a further ten years and then tests this against a number of options for acquiring and operating series-600 aircraft over the same period. A copy of the business case is attached as Appendix 2. This has been redacted in parts to respect the commercial confidences of the different suppliers with whom Aurigny has been negotiating.

5.1.2 The business case is based on an analysis of a number of different procurement options. Importantly, Aurigny has not had to restrict itself to negotiating just with the manufacturer, ATR, for the acquisition of the aircraft. It has been in negotiation with specialist aircraft leasing companies with large "order books" for the series-600 aircraft, which they had been willing to sell on to Aurigny in new "factory-fresh" condition as they take delivery of them. The business case has also explored the option of leasing new aircraft, rather than purchasing them.

5.1.3 The principal features of Aurigny's business case are set out below. It demonstrates that the optimum solution would be for the purchase of the aircraft directly from the manufacturer, ATR. This will deliver an improvement in Aurigny's P&L performance of £4.1m over 10 years compared to the base case. This figure includes provision for the application of a £2.2m fee over that period by the States of Guernsey for the loan guarantees that are required to obtain the best sources of finance currently available.

5.1.4 Having reached this conclusion as it developed its business case, it should be noted that Aurigny signed a "Letter of Intent" (LoI) for the aircraft with ATR. This enabled the airline to "lock in" the terms of any potential acquisition with the manufacturer so that it could then present these with certainty to the STSB for its consideration. The LoI acknowledges that any acquisition is subject to the approval of the States and the reservation fee that was paid by Aurigny when signing the LoI is fully refundable in the event that the States decides against the proposals. The LoI was initially due to expire on 31st October, 2018, but Aurigny has advised that it has now agreed an extension to its terms with the manufacturer until 20th December, 2018, to enable the States to consider the matter.

5.2 <u>Acquisition Options – Purchase or Lease</u>

5.2.1 Aurigny has examined the pros and cons of either purchasing or leasing aircraft. These are summarised in Table 1 overleaf.

5.2.2 Aurigny considered a variety of proposals from three different leasing companies to lease new series-600 aircraft. The minimum lease term offered was for 8 years and the highest was 12 years. Lease rates on offer varied from between US$130,000[10] per aircraft per month to US$170,000. Only one of the three lessors was willing to include provisions within its offer to take back the existing fleet of series-500 aircraft currently owned and leased by Aurigny.

5.2.3 Having analysed the pros and cons of the different options available, Aurigny has determined that purchase, rather than lease, of new aircraft is best suited to its needs. A key driver in this decision was the relatively low cost at which loan capital has been offered to the airline by Guernsey-based commercial lenders, albeit subject to the provision of a States of Guernsey guarantee (see section 5.4).

5.2.4 Aurigny's analysis of the different acquisition and lease terms on offer has indicated that the leasing option would be significantly more expensive. Compared to its preferred purchase option (see section 5.3), its analysis indicates that a monthly lease rate of US$90,000 per aircraft per month would be necessary to prove more cost effective than outright purchase. However, as noted above, the lowest lease rate offered during the course of the acquisition process has been US$130,000.

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[10] This offer was for a new aircraft manufactured in 2017 which had been parked up pending lease or sale. At the time of negotiation, these had been unused for almost one year and the leasing company was anxious to find an operator for them. The low lease rate of US$130,000 reflects the "distressed" nature of the aircraft.

Table 1: Aircraft Purchase and Aircraft Lease - Comparisons

<table>
<tr><th colspan="2">Aircraft Purchase</th></tr>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>• Flexibility: Aurigny retains an ability to dispose of the aircraft in event of changes in operational requirements, market demands or air transport policy.
• Lower Cost: With a States' guarantee, Aurigny can access capital at a lower cost than most lessors.
• Manufacturer Relationship: As a small operator, Aurigny benefits from a direct relationship with manufacturer in terms of support.
• Aircraft Specification: Aircraft specified to match Aurigny's needs.
• Financial Structure: Assets form part of Aurigny balance sheet.</td><td>• Purchase Power: Small airlines typically lack the purchasing power of larger airlines.
• Residual Value: As the owner of the aircraft, Aurigny carries with it the risk of the aircraft's residual value.
• Capital: Ownership of the aircraft ties up large amounts of capital.
• Cashflows: Pre-delivery payments for aircraft can affect cash flow.</td></tr>
<tr><th colspan="2">Aircraft Lease</th></tr>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>• Capital: Leasing is less capital intensive, allowing airlines to retain cash for other purposes.
• Residual Value: As the aircraft value depreciates, the risk around the residual value rests with the lessor.
• Tax: Leasing is better than financing if the airline does not need the tax write-off from depreciation.
• Lease Terms: Leases can be for relatively short periods, although this is less likely for new aircraft.
• Transaction Speed: Leasing often enables an airline to acquire aircraft quickly to meet operational requirements.</td><td>• Lease Costs: Lease charges reflect the lessors cost of capital, as well as its own overheads and profit margins.
• Cash Flow: In addition to lease charges, airlines have to pay maintenance reserves to the lessor from the outset (see notes)
• Return Conditions: At the end of the lease, aircraft have to be returned to the lessor in pre-agreed condition and maintenance terms. This can trigger premature maintenance events not covered by the maintenance reserves.
• Lack of Flexibility: Lessors typically seek to secure leases for new aircraft for 8 to 10 years. Early termination of the lease is usually expensive or not permitted.</td></tr>
<tr><td colspan="2">Notes: Maintenance reserves are paid to the lessor for maintenance events (such as engine overhauls) that may take place much later, possibly after the end of the lease. At the end of the lease, maintenance reserves that remain unclaimed remain the property of the lessor.</td></tr>
</table>

5.3 Purchase Options

5.3.1 During the course of 2017 and 2018, Aurigny explored offers to purchase new-build series-600 aircraft from three potential suppliers. These were made up of, firstly, the manufacturer ATR and, secondly, two aircraft leasing companies. In the case of the latter, the lessors had ordered new aircraft from ATR which it was understood were then surplus to their requirements and which they wanted to sell on to another operator, rather than seeking to place them out on lease with their own customers.

5.3.2 This position enabled Aurigny to negotiate with the three suppliers such that it eventually received three confirmed offers. The terms offered by those suppliers are confidential and, as such, it is not possible to include within this policy letter a table directly comparing them. However, the key considerations in evaluating these offers included:

- The proposed delivery dates of the aircraft. The earliest date on offer was Q4 of 2018 and the latest was Q4 of 2019;

- The ability to deliver the aircraft with ClearVision equipment (see section 5.6.3). This is the enhanced flight vision system offered by ATR;

- The extent to which the technical specification aligned to Aurigny's operating and commercial environment (avionics, seats, cabin layout etc);

- The duration and terms of the warranties on offer. There was a difference of up to 12 months in the duration of the warranties on offer;

- Provision of crew and engineer training packages;

- Aircraft offer prices, including the associated escalation rates[11] and credit memos[12] on offer. The three net prices offered crossed over a range of US$700,000 per aircraft, of which the preferred option was around the midpoint of this range;

- The terms upon which the suppliers would be willing to assist with the disposal of the existing ATR series-500 fleet, both owned and leased. Each did offer to acquire Aurigny's two owned aircraft at differing guaranteed prices in the event that other buyer(s) could not be found. However, their proposed arrangements for the leased aircraft did differ markedly.

[11] The term "escalation rate" refers to the changes in the price of the aircraft between an agreed base date and the date upon which the aircraft is delivered.

[12] Credit memos are issued by the seller of goods or services to the buyer, reducing the amount that the buyer owes to the seller under the terms of an earlier invoice. Within this context, they represent a form of discount for the aircraft.

5.3.3 In undertaking its evaluation of the offers available, Aurigny considered the following factors:

- Over the 10 year modelling period, financing costs were all within £100,000 of each other and the P&L results were not materially different in other areas;

- Only ATR could offer ClearVision with greatest certainty;

- Only the ATR offer included a package of training and service entry support;

- Proceeds for the sale of the existing two owned series-500 aircraft were similar between ATR and one of the lessors, but substantially lower for the second lessor;

- One lessor was prepared to accept responsibility for early termination of the lease on the leased series-500 aircraft. The second only offered its best efforts to assist in sub-leasing the aircraft. ATR offered to financially support the sub-lease of the aircraft until the end of its term;

- The earlier 2018 aircraft delivery schedules required by one of the lessors would have placed significant strain on Aurigny as an organisation, resulting in additional transition costs; and,

- ATR and one of the lessors were in a position to offer extended warranty periods.

Having considered all of the above, Aurigny concluded that the ATR offer represented the best value for money and entered into the aforementioned Letter of Intent to secure the terms on offer. It is important to note that the offers from Lessors 1 and 2 have subsequently been withdrawn as they have now been able to place the aircraft involved elsewhere.

5.4 Sources of Finance

5.4.1 Aurigny has approached a number of Guernsey-based commercial lenders for sources of finance for the acquisition of the aircraft. It has also considered making an application to utilise the States of Guernsey bond proceeds as a source of finance. Having evaluated the indicative offers and the bond option, the cheapest rate of finance on offer is from one of the commercial lenders, which has offered a 10 year term on a fixed rate basis. Fixing the rate over this period has the advantage of providing greater cost certainty for the airline and is consistent with the loan arrangements put in place for the airline's previous aircraft acquisitions. At this time, the terms on offer from the commercial lenders remain confidential to them.

5.4.2 Commercial loans were previously put in place to finance the acquisition of the two series-500 aircraft currently owned by Aurigny. These arrangements have been subject to the provision of a States of Guernsey guarantee. The preferred lender on this occasion has advised that a guarantee would be required again for this proposed acquisition. An option was available for a loan without a States of Guernsey guarantee, but the additional interest charges entailed would have eliminated the P&L benefit it is anticipated the replacement project will present.

5.4.3 The P&RC has advised the STSB that, in the event that a States of Guernsey guarantee is provided and, in accordance with its established policy, it would charge a guarantee fee of up to 0.8%. The preferred lender's offer remains the most competitive, even after the application of a guarantee fee.

5.4.4 It must be acknowledged that, if there is an adverse movement in base interest rates in excess of 1% before Aurigny is able to execute the necessary purchase and loan finance agreements for the aircraft and thereby fix the rate currently on offer, the option of utilising the bond proceeds might become the more competitive. Provided that the business case continues to demonstrate that there would be a positive impact on Aurigny's P&L performance, the STSB believes this option should remain open to the airline. Whilst the P&RC does already have the States' authority to provide a loan from the bond proceeds[13], the States has generally been asked to consider the financial arrangements for the purchase of new aircraft by Aurigny.

5.4.5 As aircraft acquisitions are carried out in US Dollars, the final value of the loan can only be determined once the exchange rate applicable at the time is known. Aurigny would purchase the required US Dollars at the point that an order is placed, thereby locking-in the exchange rate (see section 5.7). A further determining factor will be the cash surplus following the repayment of the loans for the existing two ATR aircraft owned by Aurigny. This surplus will be used to fund part of the acquisition. ATR has committed to purchase these two aircraft back from Aurigny at an agreed value in the event that it is unable to sell them for more elsewhere and this value has been used for the purpose of the current financial model. However, if Aurigny is able to sell these two aircraft for more, then the available cash surplus will increase and the value of the required loan will reduce. At present, the estimated value of the loan is US$60m.

[13] Billet d'Etat XXII of 2014 – The States of Guernsey Budget-2015

5.4.6 Any financial instruments required to secure the interest and currency exchange rates that are put in place between placing an order for the aircraft and accepting delivery of them will also likely need to be the subject of a States of Guernsey guarantee.

5.5 Replacement Aircraft – Impact on Financial Performance

5.5.1 The business case has examined the impact that the replacement of the existing fleet at this point in their lifecycle with series-600 aircraft would have on Aurigny's P&L performance.

5.5.2 The base case for this analysis assumed that the existing fleet of series-500 aircraft would be retained for a further 10 year period. It should be noted that a balloon payment is scheduled to be made on the two aircraft currently owned by Aurigny in 2019. It was assumed that new loan finance would be put in place to fund this payment. In the case of the single aircraft currently leased by Aurigny, the base case assumed that this lease would be renewed upon its expiry in 2021, but at a lower monthly lease rate than is currently the case.

5.5.3 The P&L analysis took into account a range of variables, as follows:

- Maintenance cost projections, both planned and unplanned, for the current and new fleet, taking into account the manufacturer's data and adjustments made by Aurigny for the specific environment in which they operate (based on its experience of operating ATR aircraft over the last 10 years). A particular factor here has been the greater cost certainty that will arise as a result of the 4 year warranty on offer from ATR for the new aircraft;

- The additional depreciation and finance costs for the ownership of the new fleet and the elimination of the lease charge currently payable on the existing leased series-500 aircraft;

- Additional insurance costs arising from the higher value of the new series-600 aircraft;

- The use of credit memos offered by ATR during the negotiation process (see section 5.3.2)

- Transition costs, including loan arrangement fees, interest on pre-delivery deposits, legal fees, pilot and engineer training, contract pilots required to provide cover during training and removal of existing Aurigny livery/markings from the series-500 aircraft leaving the fleet;

- The value of proceeds from the sale of the existing series-500 aircraft owned by Aurigny, which ATR has committed to acquiring as a "buyer of last resort" in the event that other buyers cannot be identified. This is offset partially by the cost of ensuring the aircraft meet the "return" conditions associated with any sale;

- Reductions in delay and disruption costs and compensation payments arising from: firstly, improved serviceability of the new aircraft; and, secondly, improved reliability arising from the introduction of the ClearVision system, enabling operations at times of fog and restricted visibility; and,

- The guarantee fee of up to 0.8% charged by the States for the loan finance.

5.5.4 A summary of the P&L impact is set out in Table 2. This demonstrates that the net improvement over the baseline over the forecast period is £4.08m. A separate analysis by Aurigny indicates that its cash balance at the end of the period is £0.6m better than the baseline.

Table 2: Replacement Aircraft – P&L Impact: 2018-2028 – Baseline .vs. Proposed

	£000s
Maintenance Cost Saving:	15,976
Plus, Reduced delay & disruption and EU261 costs – reliability:	1,695
Plus, ATR Credit Memos:	333
Less, Additional depreciation & interest costs, less lease saving:	(10,853)
Less, Additional insurance cost:	(343)
Less, Transition Costs:	(575)
Less, Book loss on sale of owned ATR72-500s:	(456)
Less, Interest on pre-delivery deposit payments:	(245)
Less, Loan Arrangement Fee:	(343)
	5,189
Plus, Reduced delay & disruption and EU261 costs – ClearVision:	1,100
Improvement in P&L versus baseline:	6,289
Less, States of Guernsey Guarantee Fee:	(2,206)
Improvement in P&L versus baseline:	**4,082**

It should be stressed that the improvement in the P&L position is measured against a future baseline case that assumes that the existing ATR fleet is retained. All other things being equal, if the existing fleet was retained, then Aurigny's future P&L performance will deteriorate as a result of operating ageing aircraft. The proposed replacement safeguards against this prospect, rather than addressing Aurigny's current P&L position.

5.6 ATR72 – Series 600 – Other Benefits

5.6.1 Aurigny's business case identifies a number of other benefits that will arise from the transition to the series-600 aircraft that satisfy the business requirements set out in section 4.

5.6.2 Firstly, the aircraft features enlarged overhead lockers that are capable of carrying full-sized IATA carry-on bags. This will be beneficial following Aurigny's introduction of a new "unbundled" fare structure, leading to an increase in carry-on baggage volumes, and will support its emerging relationship with Easyjet through the new Flight Connections Partnership agreed between the two carriers. It will also reduce the inconsistency in the product standards between its jet and turboprop operations.

5.6.3 Secondly, ATR is now offering to fit the series-600 aircraft with what is called the ClearVision system, which provides the pilot with images of the runway and surrounding environment when flying in low cloud or fog. This remains subject to certification, which ATR is targeting in March/April of 2019. It will enable pilots to continue their approaches below the current decision heights. Based on an analysis of Aurigny's operations in 2015/16, ATR forecasts that 50% of current ATR flights that were cancelled due to poor visibility would have operated had they been fitted with the ClearVision system. This assessment has been borne out by Aurigny's own analysis of Guernsey Airport's data in 2017. As a launch customer for ClearVision, Aurigny was offered generous discounts by ATR for the equipment as part of the overall aircraft prices. Aurigny can refuse to accept the aircraft if they are not delivered with ClearVision installed. Once delivered, ATR has agreed with Aurigny a package of damages that will be payable in the event that the system is not serviceable when required.

5.6.4 On the basis of these analyses, Aurigny estimates that its direct operational costs, together with the associated passenger compensation payments, arising from flights that would otherwise have been delayed will be reduced by £1.1m over the forecast period. Approximately one-half of Aurigny's seat capacity between Guernsey and the UK is provided using the ATR aircraft and, as such, the system offers a substantial opportunity to reduce weather related disruption for passengers.

5.6.5 In the event that a decision is made to proceed with the replacement aircraft, the STSB has asked Aurigny to develop a plan for its consideration for the adoption of an updated livery on the new aircraft that promotes Guernsey more strongly. This would not entail a full rebranding of the airline (including a change in its name), which would be more costly. A new livery could be applied to the aircraft with very little additional cost, as their purchase price will include provision for the application of the specified livery to them. Such additional costs that there are would be limited mainly to commissioning a design and then converting that into the necessary technical drawings for painting the aircraft. This would leave the Embraer jet to be repainted at the next most appropriate point in its maintenance cycle, rather than incurring additional expense in having it repainted earlier. In the event that Aurigny is successful in bidding for the Alderney service(s) under a PSO framework, the STSB would not envisage repainting the Dornier fleet, given that the main purpose of these aircraft would be to continue servicing Alderney.

5.7 Project Risk

5.7.1 The business case identifies a number of risks around the acquisition and what mitigations could be put in place. The main points of risk are set out below.

5.7.2 The business case and the P&L projections included therein make a number of assumptions around both interest rates and exchange rates (aircraft transactions are conducted in US dollars). It will not be possible to mitigate these risks until Aurigny is in a position to sign a contract for the acquisition of the aircraft, at which point both a fixed rate swap arrangement and a currency swap arrangement can be put in place. Whilst the STSB has approved the business case, this is subject to an ongoing review of the interest and exchange rates applicable at the point when Aurigny is in a position to sign the contract and associated financial instruments that confirms that the projected financial benefits of proceeding with the replacements have not been entirely eroded by any movement in those rates in the interim.

5.7.3 The business case estimates a benefit of £1.1m arising from the introduction of the ClearVision system, which remains subject to certification by the regulatory authorities. ATR is confident that this will be achieved prior to delivery of the aircraft to Aurigny, the first of which would be due in July, 2019, with the second and third following in September and October. Nevertheless, under the terms of its contract with ATR, Aurigny would have the right to refuse delivery of the aircraft until they could be delivered with the ClearVision system certified and functioning. In addition, if after having taken delivery of the aircraft, the system was to become unserviceable, Aurigny has agreed a schedule of liquidated damages that would be payable to it in circumstances where its use would have been required as a result of inclement weather conditions.

5.7.4 The business case is dependent on Aurigny's ability to make adequate arrangements for the disposal of its existing fleet of series-500 aircraft. In the case of the two aircraft owned by Aurigny, ATR has agreed to act as the "purchaser of last resort" by guaranteeing to buy them at an agreed price if Aurigny is unable to sell the aircraft on the wider open market. In the case of the one aircraft currently leased by Aurigny until November, 2021, the business case has assumed that this will be offered to the market for sub-lease on a substantially discounted basis to assist in marketing it. ATR has agreed to make a financial contribution equivalent to half of the level of this discount. There remains a risk that the aircraft will not be sub-leased, albeit Aurigny is reasonably certain that the level of discount that has been assumed will enable it to do so.

5.7.5 In the event that delivery of the aircraft is delayed, then Aurigny will retain the ability to continue operating its two owned aircraft until the new ones arrive. It will not enter into any commitment to sub-lease its single leased aircraft until after the first new aircraft has been delivered.

5.7.6 Aurigny has negotiated an extended warranty period with ATR for the new aircraft. This will help in guarding against the failure of any components, as well as providing a greater degree of certainty to the maintenance projections that form part of the business case.

5.7.7 There are a number of wider "macro" issues where it is more difficult to judge what impact they might have for Aurigny. These include:

- The recent amendments to the ATL policy statement. In terms of the Gatwick route, the States has agreed that there should be no changes to the licensing arrangements for the Gatwick route for a further 5 years. As noted earlier in this report, the minimum complement of aircraft that Aurigny's Gatwick services require includes two ATR aircraft. In terms of the adoption of the "open skies" approach on other routes, then the STSB's guidance is that Aurigny should continue to act as an asset that is used to maintain and improve the Island's connectivity. Aurigny has advised the STSB that it views the new "open skies" arrangements as a positive opportunity to do so, albeit that this relies on the retention of a third ATR within its fleet;

- A potential extension to the runway at Guernsey Airport. The STSB is conscious that if the States does agree to extend the runway, the planning considerations involved will mean that the delivery of any such project is likely to take several years, by which point, the new aircraft under consideration will be at the midpoint of their economic life with Aurigny. In any event, given that an objective of a runway extension would be to deliver growth in passenger numbers and given Aurigny's commitment to exploring new opportunities under an "open skies" environment, the STSB does not believe that the replacement of the aircraft and an extension of the runway should be mutually exclusive.

In considering these matters, the STSB has also been conscious of the view expressed by the aviation consultants it has appointed to undertake an independent review of Aurigny's business case that the impact of "macro" events such as these will not be materially different, whether it continues to operate its existing fleet or acquires the replacement aircraft. This review has also confirmed that Aurigny's recommended approach to purchase the aircraft provides it with more flexibility to address future changes in the marketplace or ATL policy statement. If necessary, the aircraft could be sold, whereas a lease means the airline is committed to retaining it over the period of that lease (or incur penalties for returning it early). The results of this review are set out in Section 6.

6. Business Case Review

6.1 As part of the business case assurance process, the STSB commissioned the independent aviation consultant, PA Nyras, to assist it in scrutinising the business case being developed by Aurigny. This followed the assistance it had provided in reviewing and verifying Aurigny's initial fleet review (see section 2.3). In particular and, whilst not an exhaustive list, the STSB asked PA Nyras for assistance in scrutinising:

- The assumptions that had been adopted for the purposes of the business case;
- The optimum timing for the purchase of the aircraft;
- The change management factors that needed consideration in planning the fleet transition;
- The different aircraft acquisition options that had been considered;
- The risks that had been identified as requiring management;
- Any "optimism bias" that might have unduly influenced the business case's recommendations.

The STSB believes this approach is consistent with the former Scrutiny Committee's recommendation[14] that, as shareholder, it should "*receive advice from a technical aviation expert when required, especially when decisions requiring substantial financial investment are required*".

6.2 The key conclusions from the review undertaken by PA Nyras are summarised as follows:

[14] Scrutiny Committee – 2015 Security of Strategic Air Links – Recommendation 4

- The business case's main conclusion to proceed with the acquisition of replacement aircraft from ATR with the purchase terms and finance facility on offer is supported;

- The terms offered by ATR for both the sale of new aircraft to Aurigny and the purchase back of two of its existing aircraft represent a good offer in the current market;

- Given the terms available, purchase of the aircraft (with a privately financed loan supported by a States of Guernsey guarantee) is the optimal approach compared to alternatives, such as leasing;

- Aurigny has carried out a thorough exercise in preparing the business case and the assumptions that underpin it are reasonable;

- There are a number of "macro" events in the wider business environment, such as the possibility of a longer runway, open skies and Brexit, the effects of which are currently unknown. The impact of these events should not be materially different whether one orders new aircraft or continues to operate the existing fleet;

- Ownership of the aircraft, rather than leasing them, provides greater flexibility to address changes in the market environment that might develop in the future;

- The P&L projections set out in the business case are a reasonable estimate of the outcomes. The comparative maintenance cost projections for the series-500 and series-600 aircraft included within the business case are reasonable;

- The acquisition of the third new ATR aircraft for use for back-up purposes is the optimal solution based on the historical analysis undertaken by Aurigny;

- From a timing perspective, the terms on offer mean that the replacement of all three aircraft as proposed in 2019 is supported. Given those terms, it would not recommend deferring the replacement of the aircraft by a further five years until circa 2024;

- In terms of optimism bias, the business case is factual albeit with a significant number of assumptions needing to be made about the future. Those assumptions are reasonable.

During its earlier work on the Aurigny fleet review, PA Nyras had raised a number of detailed points that it felt would require more detailed analysis if a business case was to be developed to replace the ATR fleet. These have now been addressed to their satisfaction. PA Nyras has also flagged a number of detailed suggestions for Aurigny to consider in taking the project forward, notably around project management and benefits realisation, which the STSB will ensure are addressed by the airline.

6.3 A copy of the PA Nyras business case review is attached as Appendix 3 to this policy letter. Again, this has been redacted in parts to respect the commercial confidences of the different suppliers with whom Aurigny has been negotiating.

7. Consultation

7.1 The STSB has consulted the Policy & Resources Committee on the contents of this Policy Letter. The Committee has confirmed its unanimous support for these proposals and its letter of comment is attached as Appendix 4.

8. Conclusions

8.1 The STSB has, by a majority, approved the business case that Aurigny has developed for replacement of its older ATR-72 aircraft with the newer series-600 models. The STSB believes that this would represent a positive and significant investment in the resilience of the Island's air transport infrastructure at a time when security of air links is a significant concern.

8.2 The business case demonstrates that replacement of the aircraft will improve Aurigny's future P&L performance by £4.1m relative to the baseline case over 10 years. This projection includes provision for the application of a £2.2m fee by the States of Guernsey for the loan guarantees that are required to obtain the best sources of finance currently available. The aircraft would offer a superior product, most notably in terms of improved reliability arising from a younger fleet and greater resilience against foggy weather conditions that the introduction of an enhanced flight vision system that is now available would offer. As such, it will improve Aurigny's competitive position in the market place and provide greater certainty for passengers travelling to and from the Island.

8.3 Recognising that the financial benefits projected in the business case are highly dependent on the interest and exchange rates that are applicable at the time of the acquisition, the STSB's approval of the business case is conditional on these benefits not being entirely eroded by any interim movements in interest or exchange rates between the publication of this policy letter and the execution of the necessary contracts to acquire the aircraft.

8.3 At the present time, the best sources of finance are available from the private sector, subject to the provision of a States of Guernsey guarantee. This policy letter therefore seeks the States' agreement to provide such a guarantee.

However, it is recognised that movements in interest rates in the interim may in due course render the option of using the States of Guernsey bond proceeds to finance the acquisition of the aircraft more favourable. Therefore, the policy letter also seeks the States' agreement to make a loan available from this source should that become the better option.

9. Compliance with Rule 4

9.1 In accordance with Rule 4(1), the Propositions have been submitted to Her Majesty's Procureur for advice on any legal or constitutional implications. She has advised that there is no reason in law why the Propositions should not to be put into effect.

9.2 In accordance with Rule 4(4) of the Rules of Procedure of the States of Deliberation and their Committees, it is noted that the propositions have been approved by a majority of the Members of the STSB. Deputy Kuttelwascher does not support the propositions.

9.3 In accordance with Rule 4(5), the Propositions relate to the duties of the Board to carry out the States' role as shareholder of any incorporated company owned by the States, including the Cabernet Group, which is the sole shareholder of Aurigny. The Board has consulted with the Policy & Resources Committee in the preparation of this policy letter.

Yours faithfully

P T R Ferbrache
President, STSB

J C S F Smithies
Vice-President, STSB

J Kuttelwascher
Member, STSB

S J Falla, MBE
Non-States Member, STSB

J C Hollis
Non-States Member, STSB

APPENDIX 1

AURIGNY AIR SERVICES – CURRENT FLEET

Model	Registration	Year of Build	Owned/ Leased	Seats	Comment
Embraer 195	G-NSEY	2014	Owned	122	
ATR72-500	G-COBO	2009	Owned	72	
ATR72-500	G-VZON	2009	Owned	72	
ATR72-500	G-LERE	2009	Leased	72	Lease ends 11/2021
ATR42-500	G-HUET	1999	Leased	48	Lease ends 04/2020
Dornier 228	G-SAYE	1985	Owned	Upto 18	
Dornier 228	G-LGIS	1988	Owned	Upto 18	
Dornier 228NG	G-OAUR	2015	Owned	19	
Dornier 228NG	G-ETAC	2018	Owned	19	

APPENDIX 2

AURIGNY AIR SERVICES

BUSINESS CASE FOR THE RENEWAL OF ATR72 FLEET

NOTE: Redaction has been used to protect confidential terms or parties to the transaction

BUSINESS CASE FOR THE RENEWAL OF AURIGNY'S ATR 72 FLEET

October 2018 **CONFIDENTIAL** Version: Final

VERSION HISTORY

Version	Issue date	Brief Summary of Change	Owner's Name
1	4th June 2018	Initial issue	MD
2	19th September	Revised draft plus Appendices	MD and CS
3	21st September	Corrections and additions – tracked changes	MD and RP
4	3rd October	Corrections and additions – tracked changes	MD,RP,CS
Final Draft	10th October	Corrections and additions - accepted	MD

Confidentiality

It will be appreciated that ATR are highly sensitive about this offer. We have signed a confidentiality agreement so it's essential that the information summarised in this document is only publicly discussed in general terms.

Redaction : [redacted] has been used to protect confidential terms or parties to the transaction

Table of Contents

1. Introduction

1.1. Purpose of this document

This document sets out Aurigny's Business Case for the disposal of its three, 10 years old ATR 72-500 aircraft and replacement with three new ATR 72-600 aircraft in Q3/Q4 2019. The timing falls within the normal replacement window for airlines with similar fleets.

This business case evidences that the most economically advantageous offer is being procured and is affordable. It also explains the background to the proposed solution, the procurement process (both for the aircraft and the financing) and how the project will be managed.

The objectives are in accordance with delivering air services in line with to the Memorandum of Understanding in place between Aurigny and the States of Guernsey.

1.2. Structure and content of the document

The five-case model has been adopted, comprising the following key components:

- the **strategic case** - sets out the case for change, together with the supporting investment objectives;
- the **economic case** - demonstrates that Aurigny has selected the aircraft type which delivers the best economic outcome over 10 years, the expected life of the aircraft in Aurigny service. It demonstrates that Aurigny has selected the most economically advantageous offer, which best meets the existing and future needs of the company and optimises value for money;
- the **commercial case** - sets out the context and content of the proposed transaction;
- the **financial case** - confirms the funding arrangements, affordability and the effect on Aurigny's financial statements;
- the **management case** – details the plans for the successful delivery of the scheme to cost and time and assesses the project risks.

1.3. Letter of Guarantee

This Business Case seeks the approval of the States, as Aurigny's Shareholder, to provide a 'Letter of Guarantee' to support a fixed interest rate 10-year bank loan that will be used to pay for the aircraft. Three commercial lenders have provided funding offers. Pricing is most advantageous where a States of

Guernsey guarantee is provided in favour of the lender. The business case has been prepared under the assumption that a guarantee will be provided, hence it is a condition precedent. Absent a guarantee, management's assessment is that the economic case cannot be made.

1.4. Project Assurance

This Business Case was approved by the Board of Directors of Aurigny.

It is understood that, as part of the assurance process, the STSB will commission external aviation expertise to provide technical knowledge and guidance to assist it in scrutinising this business case. The intention of this review will be to ensure that it has raised with the company the questions and issues relevant to an acquisition of this nature and identified significant omissions. It is understood that it will be seeking assurance on:

- The factors that have been considered in recommending the adoption of the ATR 72-600 as the basis for the fleet renewal;
- The underlying assumptions that have been adopted for the purposes of the business case;
- The change management factors that have been identified as requiring planning in transitioning from the series 500 to the series 600 aircraft;
- The aircraft acquisition options that have been considered; and,
- The risks that have been identified as requiring management.

[redacted]

2. EXECUTIVE SUMMARY

Following the States' Strategic Review, Aurigny conducted a review of its fleet. It concluded that a 70-80 seat Turboprop fleet should remain the backbone of its regional services fleet as well as operating two of the daily London Gatwick services and providing back-up for the Embraer E195 jet.

After a succession of higher than anticipated maintenance events on the currently operated ATRs, Aurigny's Board commissioned a paper to evaluate the options to replace the existing fleet of ATRs with new generation ATR 72-600 aircraft and concluded that the fleet should be replaced - provided that suitable aircraft could be sourced and viable commercial terms negotiated.

Four benefits are sought from the renewal of the fleet:

- Control of maintenance costs: there is clear evidence that costs increase significantly as aircraft age.
- Improve despatch reliability: aircraft become less reliable and require more days in maintenance as they age.
- Take advantage of preferential terms to acquire and finance new aircraft.
- Improve customer experience through introduction of technology which permits approaches and landings in low visibility weather conditions.

In its negotiations:

- Aurigny has sought to take advantage of the current ATR market which may currently be characterised as 'soft' due to lessors having over-ordered aircraft and made worse by the US-imposed embargo on Iran has left ATR unable to deliver aircraft due to have been delivered to Iranian airlines in 2018.
- Aurigny have engaged with ATR and four aircraft lessors, to explore what terms might be offered - seeking to take advantage of current market conditions.
- ATR has confirmed that it could offer aircraft with an Enhanced Vision Landing System, known as Clearvision, on new-build ATR 72-600 aircraft thereby enabling Aurigny to provide a markedly improved service in foggy conditions which, in turn, places Aurigny and Guernsey at a competitive advantage;

Management's objective has been to secure offers that would source new aircraft on advantageous terms (either to purchase or lease); sell the 2 currently owned ATR aircraft at values close to current 'book value'; and seek to minimise the liability resulting from ceasing operation of the leased ATR 72-500;

Aurigny have negotiated terms with ATR which meet its requirements and satisfy the above criteria. A 'Letter of Intent' has been negotiated with ATR on advantageous terms and attractive financing that would see its existing fleet of 3 ATR 72-500s (built in 2009) replaced with 3 new ATR 72-600s to be delivered in Q3/Q4 2019.

The proposed transaction offers the following:

- An improvement in Aurigny's P&L of £6.3 million over the next 10 years (£4.1 million after the charge levied by States for the provision of guarantee to a Lender) – resulting from lower total costs of ownership/financing and operation; [redacted] have issued an indicative proposal to finance the aircraft at an interest rate of [redacted]%, fixed for 10 years subject to a States of Guernsey guarantee. Aurigny have estimated, on what it believes to be a conservative basis, that 'Clearvision' will only contribute £1.1 million to the £6.3 million P&L improvement identified above over the course of the next 10 years

- A self-contained transaction, no investment required by the States of Guernsey – other than the provision of a States guarantee. The States' fee for providing the guarantee (0.8%) will cost Aurigny £2.2 million over the 10 years of the business case.

- A transaction that is cash positive against 10-year forecasts with manageable cash flows;

- Significant reliability gains and increased certainty over maintenance costs from new aircraft;

- An option for the two currently owned ATR 72-500 aircraft to be sold to ATR at close to book values and ATR to contribute to sub-lease of leased ATR 72-500. If a higher sale value can be achieved, Aurigny will be free to sell the aircraft to a higher bidder. ATR's offer is £250k per aircraft less than the value that the aircraft are valued at in Aurigny's accounts;

- Improved customer experience - the new aircraft will be delivered with the new[1] Clearvision technology which will enable the aircraft to land in poor visibility conditions.

- Opportunity to move to 'Guernsey branding' without need to repaint ATR aircraft – subject to a separate review;

- A 'Letter of Intent' ("LOI") – see Appendix signed with ATR commits them to the terms of the LOI until 20th December, 2018. [redacted] ATR will almost certainly require the purchased aircraft to be delivered before the end of 2019. In the event that the purchase is not supported, the reservation fees paid to ATR ($200,000 per aircraft) will be returned.

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[1] While this technology is new to the ATR, 'Enhanced Vision Systems' have been successfully operating on military and other commercial aircraft types for many years.

Having considered the various options, it is requested the STSB seeks approval from the States for:

- Aurigny to purchase 3 new ATR 72-600 aircraft from ATR on terms set out in the Letter of Intent;
- The sale of Aurigny's 2 currently owned ATR 72-500 aircraft on the best terms available;
- The sub-lease of the 1 ATR 72-500 currently leased from LEASING CO. #1 on the best terms available;
- the States of Guernsey to provide a States of Guernsey guarantee to support financing of the three aircraft on the most advantageous terms;
- Aurigny to secure commercial financing for the aircraft on terms set out in Section 5 of this Business Case.

3. STRATEGIC CASE

Aurigny is tasked with delivering air services in accordance with its Memorandum of Understanding with the States of Guernsey as well as delivering on the outcomes of the States' 2017 Strategic Review. Key objectives include:

- Aurigny should be viewed as, and act as, an economic enabler for Guernsey;
- Overall losses need to be curtailed: the airline should be economically self-sustaining and achieve break-even, net of the cost of operating the Alderney routes/PSO and the financing costs of the overdraft provided by the States of Guernsey;
- Aurigny's services should offer high levels of reliability and punctuality.

This proposal to renew the ATR fleet aims to enhance Aurigny's ability to achieve the above objectives - acting as an economic enabler and securing the lifeline London Gatwick routes while continuing to provide the Bailiwick with a wide range of regional air service connections.

At a meeting which took place on 25th September 2018, the Presidents of the Policy & Resources Committee, Committee for Economic Development and the States Trading Supervisory Board jointly agreed that Aurigny should be recognised as Guernsey's provider of connectivity, its air infrastructure asset and, while fulfilling this role, it is to move towards break-even (on the basis set out above).

This business case forms part of the plan for the airline to become economically self-sustaining through lower costs of operation, enhanced reliability through the deployment of newer more technically reliable aircraft as well as the benefits of Clearvision - a landing aid which will help reduce the incidence of delays and diversions attributed to poor visibility[2].

This business case demonstrates that by renewing its fleet of ATRs, Aurigny will:

- Improve its financial results and move towards break-even;
- Improve the reliability of its services

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[2] It is anticipated that even if a decision to extend the runway at Guernsey (which would enable the provision of enhanced Instrument Landing Systems- 'Cat II') it is unlikely to be delivered for many years – therefore the island's reputation as 'a difficult place to reach' in foggy conditions will continue to suffer. Clearvision will reduce the incidence of reduced visibility disruption.

- Improve customer experience
- Reduce and give greater certainty/predictability over its maintenance costs

This approach is consistent with the fleet review recently commissioned by Aurigny in response to the recommendation in the P&RC's Strategic Review that the composition of Aurigny's fleet should be examined and consideration should be given to whether it was optimal for the current role that it undertakes on behalf of the States of Guernsey. The review which was prepared by Energy Aviation Services Ltd. and subsequently reviewed by PA Nyras concluded that:

- The current multi-type fleet is driven by the need to serve three distinct market areas. Unless the market areas to be served change, there are no viable options to simplify the number of main types operated;
- Both the ATR and Dornier fleets currently feature a mixture of models;
- The current ATR fleet will be simplified when the ATR42 leaves the fleet (if sub-leased or at the latest in Spring 2020 when its lease ends);
- The potential exists to easily upgrade the ATR 72-500s to the latest ATR 72-600 with the possibility of enhanced reduced visibility operational capabilities;

In seeking to renew its current ATR fleet it will need to be demonstrated that the above strategic objectives will be satisfied.

4. Economic Case

4.1. Introduction

Aurigny's current ATR 72 fleet consists of two owned ATR 72-500 aircraft and one leased ATR 72-500. One of these aircraft acts as a fleet standby/spare aircraft for both the ATR fleet and the larger Embraer 195 jet.

In addition to the ATR 72 aircraft, Aurigny also has a smaller leased ATR42-500 aircraft in its fleet, although this aircraft is not currently assigned to any flying - it is intended to sublease this aircraft until the end of its lease.

This section examines fleet replacement options for the ATR 72 fleet and two ownership models – lease or purchase.

4.2. Background

The current ATR fleet at Aurigny is composed as follows:

Model	Msn	Reg	Year of Man	Owned/Leased	Comment
ATR 72-500	852	G-COBO	2009	Owned	
ATR 72-500	853	G-VZON	2009	Owned	
ATR 72-500	891	G-LERE	2009	Leased	Lease ends Nov. 2021
ATR42-500	584	G-HUET	1999	Leased	Lease ends Apr. 2020

Table 1 – Current Aurigny fleet *(source: Aurigny)*

The two owned ATR 72-500s were financed over a 10-year period with a final balloon payment of £8m due in February 2019. This balloon payment will need to be refinanced.

The two leased aircraft are both leased from Nordic Aviation Capital the world's largest lessor of turboprops who have a large portfolio of ATRs.

All three ATR 72-500s are of a similar age, currently 9 years old whereas the ATR42 is now 19 years old.

Of the three ATR 72s, one aircraft acts as a standby aircraft providing cover for both the ATR fleet and the larger Embraer 195 jet in the event of either planned maintenance or unforeseen technical problems. This aircraft can also be used to reduce delays following non-technical disruption by allowing one line of afternoon ATR flying to be recovered on time using the normally planned crew. For a comprehensive assessment of the benefits of owning a backup aircraft see Appendix 3.

4.3. Why replace the current fleet of ATRs at this time?

It would be possible to continue to operate the existing fleet for a number of years as although the fleet of ATRs (owned and leased) is approaching 10 years old, the aircraft are in good condition and have been well maintained. However, if the current fleet is retained the opportunity will be missed to:

- replace the fleet with new aircraft on advantageous terms that will improve the financial performance of the airline over the next 10 years;
- improve the fleet's technical reliability which is likely to deteriorate over time;
- reduce business risks that result from unplanned aircraft maintenance events – both in terms of the unpredictability of costs and the maintenance downtime;
- improve customer service and service integrity by taking advantage of the introduction of new technology (Clearvision);
- reduce exposure to EU261 passenger compensation and passenger welfare costs (hotels, accommodation, etc.).

The financial implications of retaining the existing fleet is analysed in Section 6 (base case). A key consideration is the likely escalation of maintenance costs over the next 10 years. Longer term maintenance costs on a cash flow basis are shown in Figure 1 for a single ATR 72 (msn852). These show significant levels of cost in the periods 2022-23, 2030-31 and 2034 driven by engine overhauls, and high cost propeller and undercarriage overhauls. This highlights the significant effects of aircraft aging as by this stage in the aircraft's life such levels of expenditure exceed the nominal value of the asset.

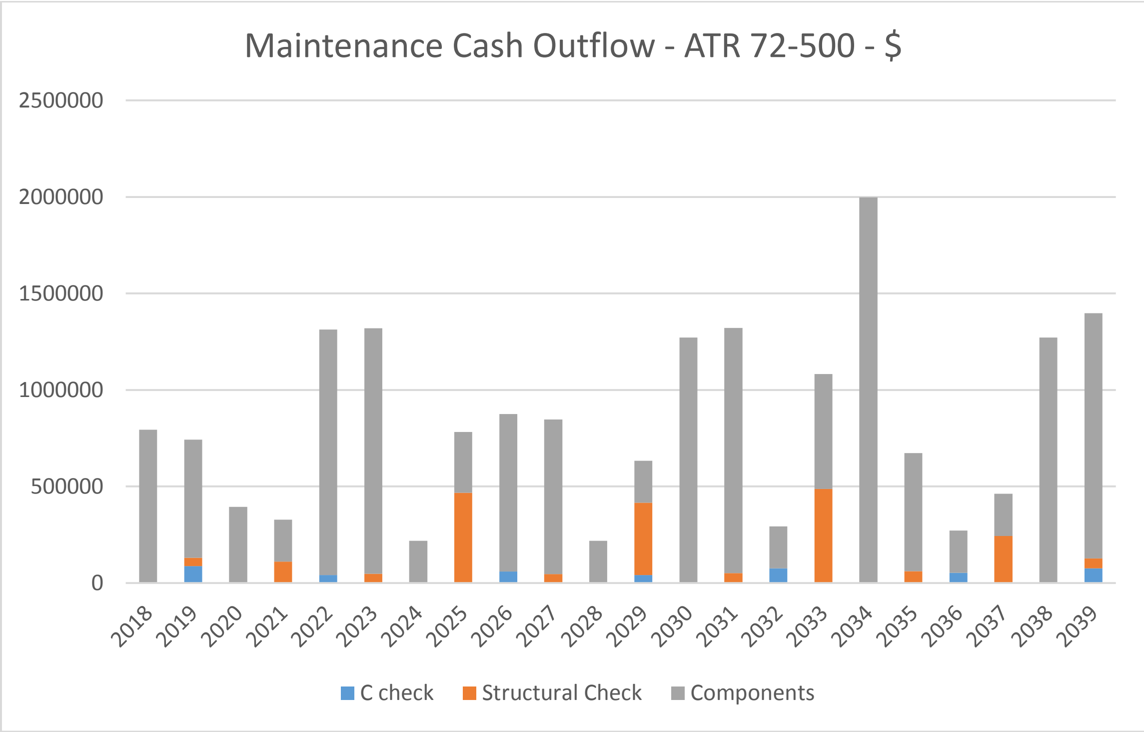

Figure 1. Example of long term Maintenance Cost forecast (G-COBO) (*source: Energy Aviation Services)*

It should be noted that the maintenance cost forecast (see Figure 1) only shows expected maintenance costs and events based on typical maintenance and contains no provision for unforeseen events such as exceptionally high engine shop visit costs due to corrosion (as experienced by Aurigny on its last owned ATR 72-200 aircraft). Such issues can have significant costs and typically affect older aircraft so are more likely to impact the existing fleet as it ages rather than new aircraft. The newer the aircraft, the greater the certainty over the likely expenditure on maintenance.

As aircraft age they become less reliable. Figure 2 presents reliability data provided by ATR for the ATR 72 based on the age of the aircraft.

This shows that compared to the current level of performance for the existing fleet it can be expected to have twice as many technical delays by 2028 as currently experienced. These delays incur costs especially if they become prolonged and incur EU261 penalty payments applicable to flights from the UK.

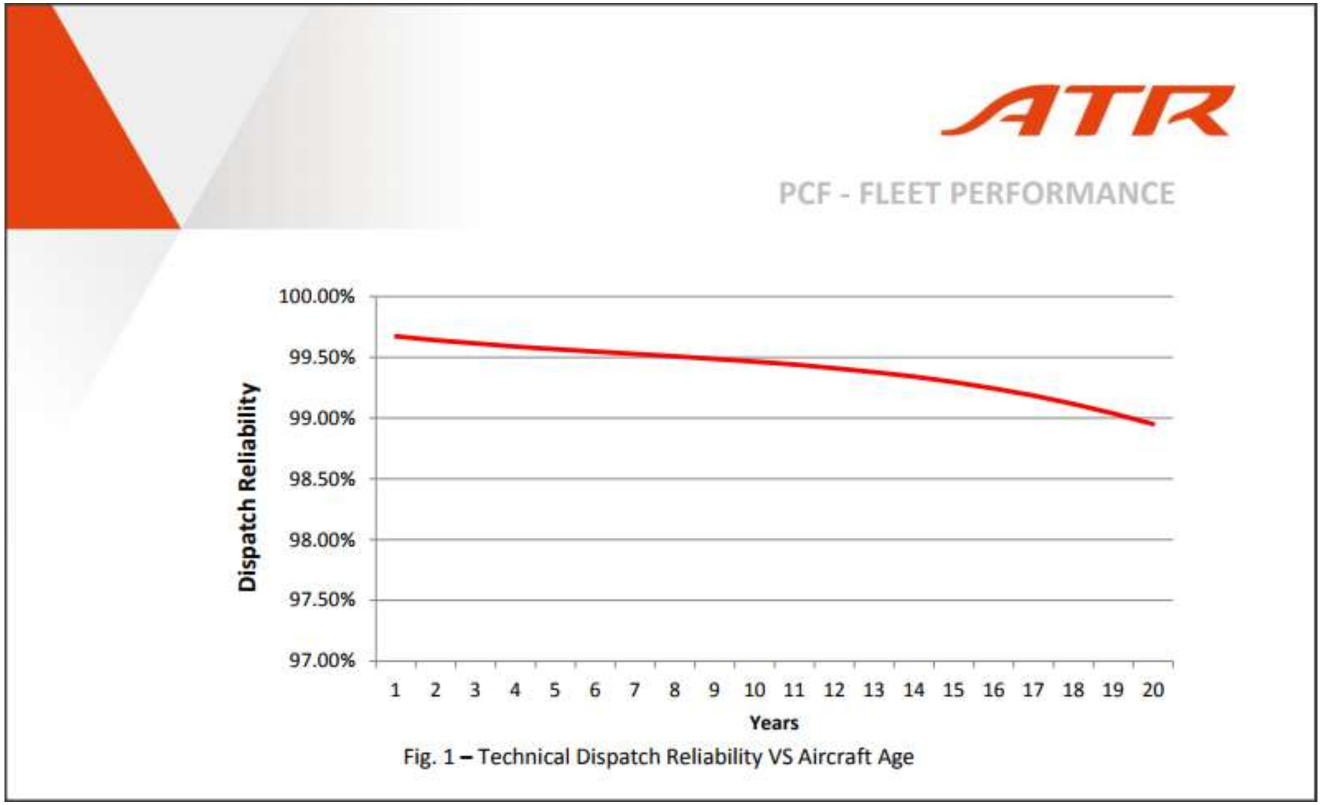

Figure 2. Variation of Technical Dispatch Reliability with ATR Age ***(source: ATR)***

A further impact as the aircraft age will be to experience longer maintenance downtimes for scheduled checks. Provided that suitable check lengths are planned then these longer down times can be accommodated as the fleet has a spare unit for maintenance cover.

However, during check periods this spare unit is in use to cover the aircraft on check rather than being available to recover any technical problems with in-service aircraft, so the impact of longer checks could be seen during these periods in terms of greater technical disruption.

In conclusion, there appear to be many benefits from considering the replacement of Aurigny's existing ATRs. The 'no change option' has been used as the baseline for the other options that have been considered.

4.4. Options assessment

4.4.1. What other types could be considered?

The fleet review considered which types of aircraft might be the best for Aurigny's fleet in the future. The only similar-sized turboprop aircraft, the Bombardier Dash 8-Q400, has a larger capacity seating (up to 82 passengers) and a much higher cruise speed. The Q400 is considerably more expensive to operate than the ATR 72-500, in that it has:

- a maximum take-off weight of 27 tonnes which is 5 tonnes higher than the ATR resulting in increased enroute and weight related airfield charges
- higher cruise speeds and resultant higher fuel costs. Aurigny's route network with its short sector distances is unable to take advantage of the Q400's higher cruising speeds[3]

Overall, the aircraft is not as good a match to Aurigny's needs as the ATR 72 and has lower operating costs than the Q400 over shorter flights (see Figure 3).

In addition, a change of aircraft type would also involve significant transition costs. Whilst a new aircraft manufacturer's proposal would include type rating training courses for example, they would not compensate for the crew time lost during this conversion training. It is estimated this would result in a need to employ at least three extra crews to cover the fleet transition period effectively (cost estimated as £[redacted]00,000). There would also be much less fleet flexibility as a transition was made (similar to the challenges experienced by Aurigny in the Trislander to Dornier change).

Another possible alternative may be to replace the ATR fleet with Embraer 170 Jet aircraft which are from the same family as the Embraer 195 already operated. While this would bring simplification in terms of needing only one group of crew to cover both fleets, the Embraer 170 has significantly higher costs than the ATR making it unattractive. Ownership costs for a used 170 are not significantly lower than for a new ATR 72 and operating costs are much higher due to the aircraft's increased weight, maintenance costs (especially the engines) and much higher fuel burns.

[3] It has been suggested that the difference between the ATR and Dash 8 can be reduced by operating the Dash 8 at lower speeds. Following evaluation it has been determined that it will make little difference to the cost disadvantage that the suffers against the ATR in Aurigny's route network.

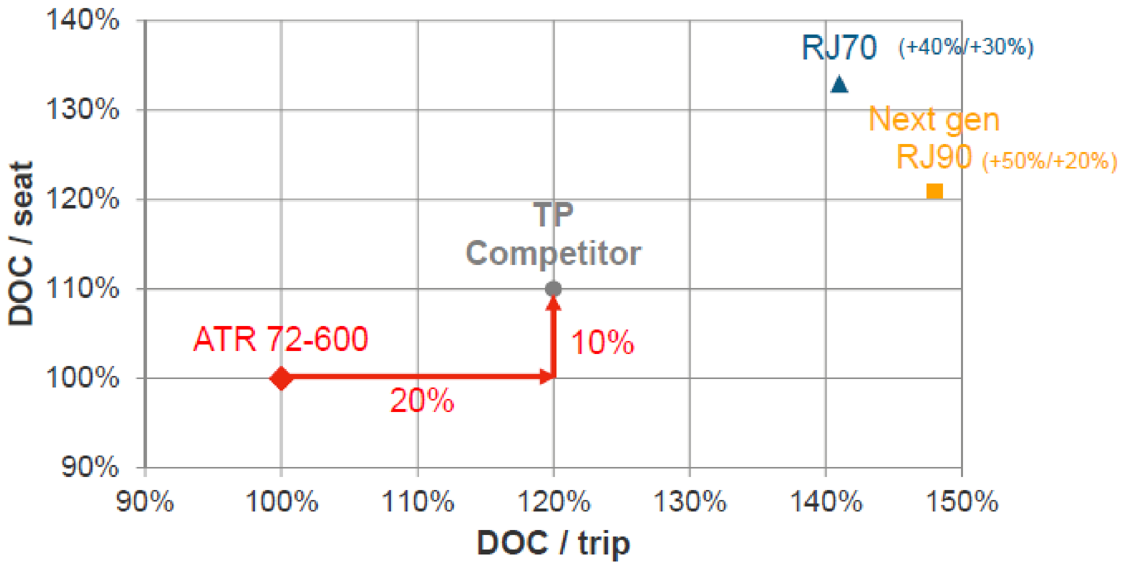

Figure 3 - ATR vs Competitor Cost Comparison ***(source: Energy Aviation Services)***

In conclusion, our analysis has shown that the ATR is the most suitable aircraft for Aurigny's current (and foreseeable) route network.

4.4.2. Opportunity to adjust fleet mix

We have considered whether updating the ATR fleet offers the opportunity to adjust Aurigny's fleet mix.

Currently, the airline owns one ATR 72 which is used as a standby aircraft to provide cover to both the ATR fleet and the Embraer 195 jet. An alternative scenario where the fleet standby is changed to a second Embraer 195 jet has been evaluated. This evaluation considered replacement of the existing ATR 72-500 (assumed for simplicity to be the leased aircraft) with a leased used Embraer 195 and was based on a lease offer from [redacted].

For comparison, a change of standby aircraft to an ATR 72-600 has also been considered (although this scenario is intrinsic in the subsequent fleet replacement scenarios evaluated later in this paper). Figure 4 shows the comparative annual fixed costs for the standby provision.

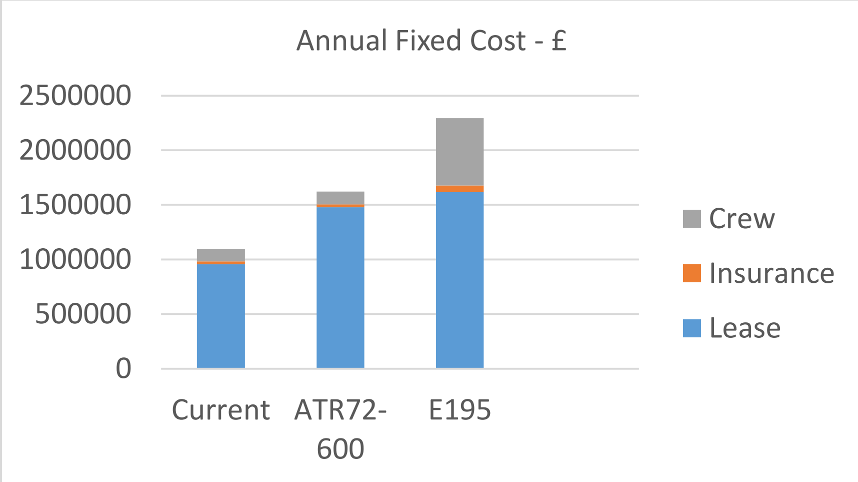

Figure 4 - Standby Aircraft Cost Comparison *source: Energy Aviation Services)*

The switch to an Embraer 195 standby aircraft would increase annual fixed operating costs by £1.2m over the current fleet (a switch to ATR 72-600 adds £523k which is £677k less than the Embraer 195 option).

Analysis of historic flight records shows that around 130 Gatwick flights used the standby ATR 72 in place of the Embraer. If a 75% load factor on the Embraer is assumed, then use of a standby ATR does disrupt a proportion of passengers since the aircraft does not have the capacity to carry the Embraer load.

[redacted]

On this basis, it would not be economic to adopt an additional Embraer 195 as the fleet standby even though this would provide better overall service to the Gatwick route. A standby Embraer 195 would not provide as effective a back-up to the ATR routes as the third ATR since it would have increased operating costs and is larger than necessary. On this basis, all future fleet scenarios will consider the ATR as the fleet standby type.

See Appendix 6 - Usage of back-up ATR for a comprehensive assessment of the usage of the back-up ATR.

4.5. Benefits of the ATR 72-600

The ATR 72-600 is the latest production version of the ATR 72. Compared to the current ATR 72-500s operated by Aurigny it offers the following new benefits:

- **Modern Avionics** – The ATR 72-600 is equipped with a new Thales avionics suite which is can easily offer all the latest avionics capabilities such as LPV (Satellite based) approach capability and ADS-B out functionality via simple options. These future-proofing capabilities would need to be added to the existing ATR 72-500 fleet via high cost modifications and even so the existing fleet would retain its existing 1980s platform with increased obsolescence risks.
- **Increased technical reliability** – The ATR 72-600 features several upgrades that bring greater reliability in service. These include LED cabin and exterior lights that have much longer operational lives and LCD EFIS screens. Again, such capabilities can be added to the existing fleet via modifications which are starting to be offered to the market but require additional investment in progressively older airframes.

- **Enhanced cabin with larger overhead hand baggage stowage** – the new ‘Armonia’ cabin design of the ATR 72-600 features enlarged overhead lockers capable of carrying full size (IATA/easyJet) carry-on bags efficiently. This enhancement will be extremely beneficial following Aurigny’s move to an unbundled fare operating model which has led to an increase in carry-on baggage volumes.
- **Increased operational reliability** - the ATR 72-600 has the option to be equipped with the Elbit ClearVision system. This introduces nose mounted infrared cameras that provide external imaging through cloud and fog displayed on a head-mounted display.

This display combines the external image with essential flight data and also a synthetic terrain image derived from an onboard terrain database to provide a capability known as an Enhanced Flight Vision System (EFVS). The system provides the pilot with images of the runway and surrounding environment even when in conditions of low cloud or fog. It will function at any runway whether equipped with an ILS system or a non-precision approach.

EASA operating rules already provide operational credit for aircraft equipped with EFVS (currently typically Business Jets) in terms of reduced Runway Visual Ranges and a lower decision height. For operations at Guernsey these would result in a 100ft decision height and an RVR of 350m rather than the current 200ft and 550m for non-equipped aircraft[4]. Ongoing work between ATR and EASA is expected to bring revised rules into force during 2018 and approval of ClearVision that will allow operations with EFVS to continue below the 100ft decision height to touchdown with a 300m RVR.

ATR have been testing the ClearVision system and have brought a Clearvision equipped aircraft to Guernsey during low visibility conditions to demonstrate how the real word capability of this system. They expect the system to be certified Q2 2019.

Based on analysis of Aurigny operations in 2015-2016 and a revised RVR of 300m, ATR forecast that 50% of flights that were cancelled due to poor visibility would have operated if it had been flown by a ClearVision equipped aircraft. This assessment was borne out by Aurigny's own analysis of Guernsey Airport's 2017 data – see Appendix . With this level of improvement in operational performance it is estimated that Aurigny will save at least £100k per year in disruption costs (out of a total budget of £1 million p.a.). This improvement is credited into the subsequent analysis of the ATR 72-600 fleet options from 2020 onwards. The ClearVision system cannot be retrofitted to older ATR models so is unique to the ATR 72-600.

In conclusion, the most attractive option would be to update the fleet with the new ATR 72-600. This newer model offers a more modern aircraft with a very simple transition as only short differences training is needed to allow existing ATR-500 pilots to operate the -600.

[4] As mentioned earlier, in 2017 there were 47 days where the visibility was below the required minima. We estimate that the reduced minimum visibility requirements will lead to an improvement of 40-50% in terms of delays during foggy periods.

5. Commercial Case

This section sets out the commercial case for the acquisition of the replacement ATR aircraft and summarises the process that has been followed.

5.1. Ownership options

We have considered the two main options for the acquisition of replacement aircraft – purchasing and leasing. Both options have advantages and disadvantages:

5.1.1. Advantages of Purchasing aircraft

Advantages of purchasing include:

- **Flexibility** – If it is possible to own the aircraft and secure financing that is not tied to the aircraft, Aurigny would retain the ability to dispose of the aircraft should the operational requirement change (for example as a result of a changes in air transport licencing policy; the competitive landscape; access to London Heathrow; substantial increases in airport landing fees; changes in States' policy); etc.;

- **Lower cost** - Our cost of money, with a States guarantee, is lower than a lessors'. While it may be possible to take advantage of the lessor's purchasing power from their multiple aircraft orders - we have to pay for the lessor's overheads/profits;

- **Relationship with the manufacturer** – for a small operator, a direct relationship with the manufacturer is valuable in terms of support, especially during the introduction phase;

- **Aircraft specification** - Ability to specify the aircraft to match Aurigny's needs;

- **Financial structure** – the aircraft assets form part of the company's balance sheet.

5.1.2. Disadvantages of purchasing

Disadvantages of purchasing include:

- **Purchasing power** - typically, small airlines lack purchasing power as compared to large operators or lessors so they are unlikely to be able to secure the best possible deal;

- **Residual value risk** – remains with the airline;
- **Capital** – making large investments ties up capital;
- **Cashflows** - Initial cashflow on pre-delivery payments require funding.

5.1.3. Operating lease advantages

Advantages of leasing, from Aurigny's perspective, would include:

- **Capital** - leasing is less capital intensive than cash purchase – allowing the airline to use its cash for other purposes rather than keeping it tied up in an aircraft.
- **Residual value** - leasing moves the residual value risk to the lessor. Aircraft values depreciate over time.
- **Tax** - leasing is better than financing if the airline does not need the tax write-off from tax depreciation.
- **Lease term** - Leases can be for relatively short periods, although this is less likely for new aircraft.
- **Speed of transaction** - aircraft can often be acquired quickly to meet an operational need as in the case of the ATR 42 for the London City route.

5.1.4. Operating leases disadvantages:

The main disadvantages, from Aurigny's perspective, include:

- **Monthly rental costs** – reflect the lessor's cost of money, the cost of its operation and its profit margin.
- **Reduced cash flow** - lessors require maintenance reserves which are paid to the lessor from day 1, for maintenance events due many years later. At the end of the lease maintenance reserves that remain unclaimed remain the property of the lessor; they also require, security deposits (usually in cash and equivalent to 3 month's rental);
- **Return conditions** - when returning an aircraft to the lessor at lease end the aircraft must be returned in a pre-agreed condition/maintenance condition. This often necessitates premature maintenance events which are not covered by the maintenance reserves. The return conditions

protect the lessor but not the lessee. It’s also possible that high utilisation will be penalised and for any defects not deemed to be ‘fair wear and tear’;

- **Lack of flexibility** - lessors typically seek to secure leases for new aircraft over a period of 8 to 10 years. Once a lease is signed it is very expensive/impossible to terminate a lease early – unless it suits the lessor. Therefore, it has to be considered to be a firm commitment for the duration of the lease. A lessor may agree to an early return if the lessee pays the remaining lease payments.

While not relevant to Aurigny:

- a lease can place restrictions on the operations of the aircraft. A lease may restrict where you can base or how you can operate the aircraft. A lease may restrict geographic regions to which it can be flown – such restrictions are set out in the lease agreement.

- tax advantages may be lost. An aircraft can be written off to a zero-tax basis. Leases don't allow you that benefit as the lease payments can only be taken as expenses. This may result in higher short-term taxes as the aircraft depreciation allowance can easily exceed the lease payment deductions.

Given Aurigny’s ownership structure, outright acquisition of the aircraft (as compared to an Operating Leases) will better suit Aurigny’s needs given its financing options/cost of money utilising a States loan guarantee.

This view was reinforced by our analysis (see Appendix 10), that assessed what Operating Lease rate would be required to deliver similar results to those achieved by acquisition and financing.

The analysis shows that we would need to be offered a monthly operating lease rate of $90,000 to achieve similar financial results. The best offer that we’ve seen for operating leases for new aircraft has been in the region of $140/150,000 per month. Used ATR 72-600s built in 2013/2014 are being offered in the market at around $90-100,000/month. If Aurigny were to lease 3 new aircraft at an additional cost of $50,000 per month for the period covered by this business case, that there would be negative impact of around £12 million.

We therefore recommend that the States should support this business case to acquire and finance the new aircraft instead of leasing the aircraft.

5.2. Sources for purchasing ATR 72-600 aircraft

Whilst ATR, the manufacturer, are the obvious source for the purchase of a new build ATR 72-600, Aurigny has established relationships with leasing companies, two of which were able to offer new aircraft for sale from their existing order rather than lease. This opened the possibility of competition within the purchase option.

It should be noted that, as anticipated, ATR propose a more comprehensive package of support credits (discounts) compared to that offered by the leasing companies who have more restricted, less valuable, credits attached to their aircraft.

For the purposes of the analysis in this business case, the purchase case is based on the proposal set out in ATR's LOI.

5.3. Sources of Finance

We have looked at various sources of financing. We considered, and rejected, financing from the States of Guernsey Bond Issue as, following informal discussion, it appears likely that the financing cost will exceed the offers from [redacted].

Aurigny has approached three Guernsey-based commercial lenders:

[redacted]

[redacted]

The following table summarises the indicative offers for financing received from these lenders:

Note: 3 month LIBOR 10 year fixed interest rate indication from [redacted]

The offer from BANK #1 is closest to our needs therefore we have used these terms to model the Financial Case in Section 6. While only the BANK #3 option requires full mortgage security[5], BANK #1 and BANK #2 would require a guarantee from the States of Guernsey. The fee for this guarantee has been assumed at 0.8% and this fee has been shown as a separate cost line in our financial modelling.

5.4. Procurement process

The procurement process has taken place over the last 18 months. The many offers and counter-offers received over this period are summarised in Appendix .

We were contacted by ATR in Q1 2017 to establish whether we would be interested in replacing our aircraft, and in particular whether Aurigny would be interested in becoming a launch customer for their 'Clearvision' product. They made an offer to sell us new aircraft ($[redacted]m) but as they were unable to confirm the availability/timing for Clearvision we decided not to proceed.

ATR's offer prompted us to consider whether it might be worth looking at early versions (2013-2015) of the ATR 72-600 which were on the market and available for sale or lease. Having reviewed the lease rates/terms we decided not to pursue them as the financial case was weak:

- Manufacturer's warranties had expired and there would be no manufacturer support;
- The reduction in maintenance costs as compared to our existing fleet was insufficient;
- The improvement in reliability would not be delivered to the levels we are seeking in connection with our mission under the Memorandum of understanding or reduce 'EU 261' compensation payments;
- ATR were not offering 'Clearvision' as a retrofit programme and even if they were Clearvision would not be capable of being retrofitted to any but the most recently built aircraft. Therefore, the cost saving/reliability benefits from the new technology required to help make the business case viable would not be achieved.

In January /February 2018 we were approached by three leasing companies who had new aircraft available for lease with delivery in 2018/2019. We sought offers from them based on a technical/option specification that matched our current and foreseeable requirements.

[5] A mortgage on an aircraft would mean the the financing would be tied to the specific aircraft. In the event that Aurigny wished to sell the aircraft, the terms of the mortgage-backed financing may make the termination impossible – or expensive.

LEASING CO. #2 plc, LEASING CO. #1 and LEASING CO. #3 all responded with lease rates at between $155k to $170k per month (plus reserves) and in March LEASING CO. #1 made an improved offer of $[redacted]k per month[6], but a review of the offer confirmed that even at $[redacted]k per month it would not be possible to make a business case to replace our ATR 72-500s. In addition, they could not guarantee that they could provide the Clearvision modification (either as a factory or retrofit).

From discussions with the lessors and ATR it became clear that the leasing companies had over-ordered ATRs and were becoming desperate to place their aircraft and ATR themselves were also facing an order short-fall in 2019.

In late March/early April, ATR confirmed that the terms of their offer made in April 2017 would be honoured and that they were in a position to confirm that Clearvision could be offered.

In late April 2018 we received an offer from LEASING CO. #1 to purchase the 3 new ‘white-tail’ ATR 72-600s that had been manufactured in 2017. The offer price was $[redacted]m per aircraft. While this was an attractive price, LEASING CO. #1 were unable to confirm that they could commit to installing Clearvision (ATR said that they could not). As LEASING CO. #1 were seeking an immediate answer and there were various other drawbacks, we were unable to proceed.

Based on our assessment of the state of the market (see Appendix 9 - ATR 72-500 Market assessment and Ascend Market values) in Q2 2018 (i.e. oversupplied with manufacturer and lessors competing to sell aircraft) and the financing offers that we had received (see Appendix), we then entered into a series of negotiations with [redacted].

The negotiations with the three organisations resulted in three confirmed offers:

ATR, offered three new aircraft for delivery in Q3 2019. All the aircraft to be delivered with Clearvision fitted and with performance guarantees for the operation of this system. ATR were also offering to purchase our two owned ATRs and support the sub-leasing of the currently leased ATR 72-500;

[redacted] offered (i) a 10 year lease on 2 aircraft or (ii) sale of 2 aircraft in Q4 2018. None of these aircraft would be delivered with Clearvision although it might be possible for this to be fitted subsequently at additional cost[7]. They also offered to purchase our two owned ATRs.

6 [redacted]

7 It should be noted that ATR have stated that they are not offering Clearvision for retrofit. Clearly, they have an interest in trying to sell new aircraft and see the offer of Clearvision only as a factory-fitted option gives them an advantage over the leasing companies.

[redacted] offered (i) a lease of 3 aircraft or (ii) a sale of 3 aircraft. None of these aircraft would be delivered with Clearvision although it might have been possible for this to be fitted subsequently at additional cost (but ATR said that they would not commit to sell Clearvision as a retrofit). LEASING CO. #1 were also offering to purchase our two owned ATRs and accept the early termination of the lease of the currently leased ATR 72-500 (but not the ATR 42-500).

The three offers for the purchase of aircraft were remarkably close to each other. Over the 10 years modelled:

- Financing costs were all within £100k of each other;
- P&L results were not materially different in other respects;
- Only ATR could offer Clearvison with certainty. At best there would be a significant delay in implementation if were to have bought aircraft from LEASING CO. #1 or LEASING CO. #2 and not from ATR;
- Depreciation costs would be £[redacted]k more with LEASING CO. #1 offer to sell their aircraft and an additional £[redacted]k for the LEASING CO. #2 offer;
- ATR's offer included £[redacted]k worth of training costs which neither of the other offers include;
- ATR's offer included $[redacted]k of credit memos for goods/services/spare parts that neither of the others included;
- Proceeds for Aurigny's currently owned ATR 72-500 would be similar between ATR and LEASING CO. #1 (within $[redacted]k), but the offer from LEASING CO. #2 was significantly lower ($[redacted]m less);
- Only LEASING CO. #1 could offer certainty over the future of the ATR 72-500 aircraft which we have currently on lease from them; and
- The delivery schedules for the aircraft from LEASING CO. #1 (immediate) and LEASING CO. #2 (Q4 2018) would have placed considerable strain on Aurigny's organisation and resulted in additional transition costs – although LEASING CO. #1 later offered later delivery slots.

In summary the 'best and final' offers were:

TABLE REDACTED

Having considered the above factors, it was decided that the ATR offer represented superior value and was selected as the preferred option.

[redacted]

[redacted]

5.5. Disposal of Aurigny's owned ATR 72-500s

As previously stated, Aurigny currently owns two ATR 72-500s (G-COBO and G-VZON) which it will need to sell as part of the proposed transaction.

The current market for used 10-year-old ATRs is weak (See Appendix 9 - ATR 72-500 Market assessment and Ascend Market values) and there is no certainty that we would be able to sell the aircraft at or around the value that the aircraft are held in Aurigny's accounts.

While we will actively market the aircraft to achieve the best sale price, to give certainty to this business case we have negotiated that ATR, at Aurigny's option, will acquire the currently owned aircraft for an agreed value that, based on the predicted maintenance status of the aircraft, that is £250k less than the value the aircraft are held in Aurigny's accounts. This 'book loss' is reflected in this business cases' financial modelling.

For the aircraft to be accepted by ATR, the aircraft will need to meet their 'delivery conditions'. The analysis contained in Appendix 5 confirms that the aircraft will substantially meet ATR's delivery conditioned provided that the aircraft are delivered to ATR before early 2020 (the current plan would see the aircraft delivered in Q3 2019). The only significant cost, which has been provided for, will be cost of repainting the aircraft.

The option to sell the aircraft to ATR also give certainty to the cash flows and the financing requirements for the project.

5.6. Deferred purchase options

We have considered two options to defer all or part of the purchase:

5.6.1. Deferring the transaction by 5 years

We have considered the impact of deferring the transaction by 5 years – resulting in an into service date of Q3 2024. It's almost certain that the offer from ATR will be withdrawn (or at the very least highly modified) with the following consequences:

- Clearvision launch customer preferential rates and terms ([redacted] year warranty, enhanced credit memos, Clearvision into service support) will be lost;
- Market rate price escalation ([redacted]% in our current offer) is likely to be applied causing the cost per aircraft to be $[redacted] to $[redacted]m higher resulting in higher depreciation and interest charges adversely impacting the P&L;
- Increased capital and interest repayments will adversely impact the cash flows;

- Exposure to adverse movements in interest rates, exchange rates and withdrawal of financing terms - all of which would have the potential to impact adversely on the business case. For example, a 1% increase in interest rate will add £320k per annum, on average, to costs. A 5 cents adverse move in the Dollar (e.g. $1.35 to $1.30) increases the cost of the package of 3 aircraft by £400k, and a move in the other direction to $1.40 decreases cost by a similar amount.

- Above all, it's impossible to predict what market conditions will prevail at that time and the terms that it might be possible to negotiate.

If the offer from ATR were to be maintained for 2024 deliveries (which we believe is unlikely), we estimate the adverse P&L impact would be £1 to £2m in the business case timeframe – not adjusting for NPV of the lost benefit.

5.6.2. Initial purchase of 2 new aircraft and option to purchase 3rd aircraft for delivery in 2021

We have considered whether the business case could be improved by seeking a revised offer from ATR that would delay the delivery of the third aircraft until Q3 2021, to coincide with the redelivery of G-LERE to NAC (due in November 2021).

The main advantage of this option would be to remove the risks associated with the possible inability to sub-lease the leased NAC aircraft. We have not tested this option with ATR but it is possible/likely that one consequence could be that they would only buy-out 1 of the ATR 72-500s, unless a firm order placed for aircraft No 3. It's also possible that the offer of [redacted] Clearvision for aircraft #3 would be withdrawn.

From a financial point of view this would reduce the saving over the 10 year period by £1.5 million.

From an operational point of it would be an unattractive option for a number of reasons:

- Mixed fleet – consistency issue for both the crew and public. For example, it would be impossible to offer larger, Easyjet/BA compatible overhead hand baggage lockers (we are currently limited by the size of the ATR 72-500's locker size;

- Repainting of aircraft – if the new aircraft have a new Guernsey oriented livery, one aircraft would be in the old livery for 2 more years;

- Diluted marketing benefit;

- Reduced Clearvision benefit – it would not be possible to deliver a clear message/value proposition about the benefits of Clearvision and newer/more reliable aircraft.

5.7. **Conclusion**

Having considered the various options it is recommended that States approval is sought for :

- Aurigny to purchase 3 new ATR 72-600 aircraft from ATR on terms set out in the Letter of Intent;
- The sale of Aurigny's currently owned ATR 72-500 aircraft on the best terms available;
- The sub-lease of the ATR 72-500 [redacted] on the best terms available;
- the States of Guernsey to provide a States of Guernsey guarantee to support financing of the three aircraft on the most advantageous terms;
- Aurigny to secure commercial financing for the aircraft on terms set out in Section 5 of this Business Case.

6. Financial Case

The following section should be read in conjunction with the Excel Spreadsheet Model : AUR ATR72 analysis v6g.xlsx

6.1. Base case

The baseline case for this review is the continued operation of the existing ATR fleet. This case includes the following assumptions:

- The balloon payment for the two owned ATR 72-500 aircraft is refinanced in 2019 when due at a financing term and rate used by Aurigny for its current five-year forecast, and in its 2019 Budget.
- The lease for the ATR 72-500 with LEASING CO. #1 is renewed at a lower lease rate when the current term ends (November 2021). This is a logical step as it would avoid the need to put this aircraft into return conditions and source a replacement. $[redacted] vs current $[redacted] per month
- The ATR42-500 has been addressed by accounting provisions for financial year 2017 so is not factored into the baseline as it would be neutral. The lease terminates in March 2020.
- For leased aircraft, supplemental rents are expected to cover the maintenance costs as they arise.

Figure 5 shows the forecast annual impact of aircraft maintenance and aircraft ownership costs on Profit and Loss charge and Cash Outflows for this baseline scenario to 2028. This will be used as a baseline case for comparison with alternative fleet options.

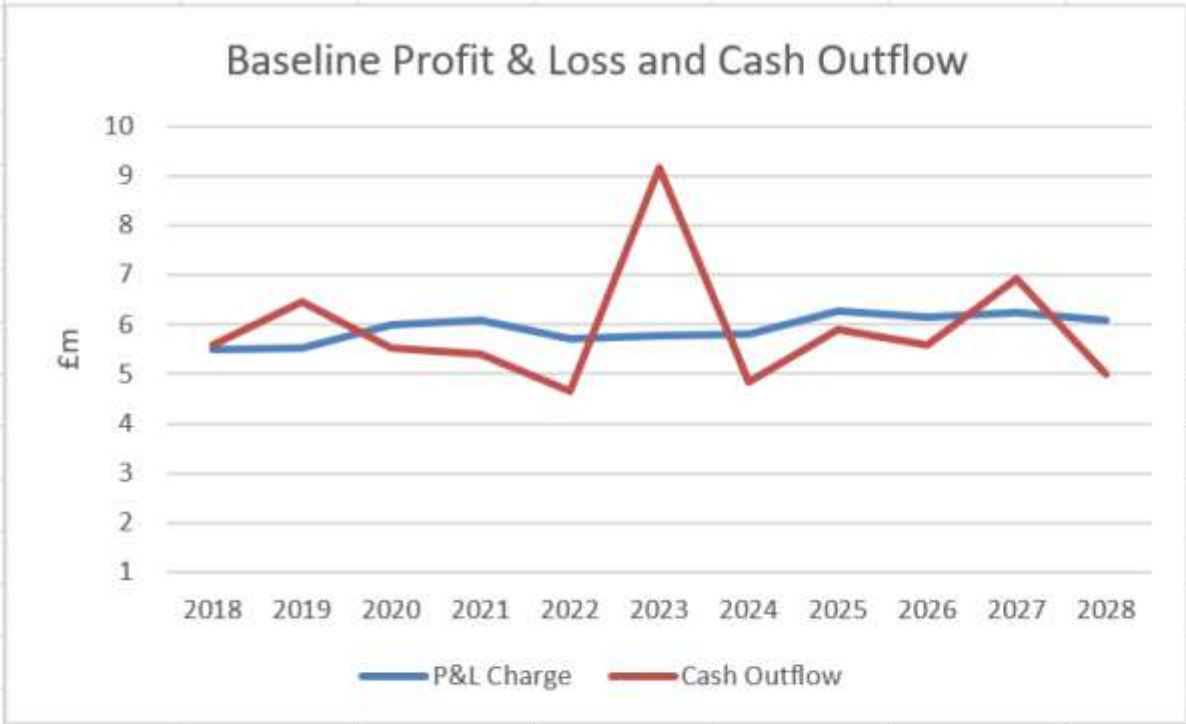

Figure 5. Baseline P & L charge and cash out-flow - aircraft maintenance and ownership costs only *(source: Aurigny)*

The baseline analysis uses current ATR cost levels with future ageing effects based on a combination of Aurigny data and data provided by ATR. The costs of ownership (lease or depreciation/capital and interest, insurance) and third-party maintenance costs are not considered as they are assumed to remain constant throughout the analysis and also across the various alternate fleet scenarios considered later in this report.

The peak in cash outflow in 2023 is due to all four engines from the owned ATR 72s requiring overhaul in that year.

6.2. Proposed transaction

6.2.1. Impact on P&L and cashflow

We have modelled the impact of the proposed transaction using our current 5-year plan, subsequently rolled forward to 10 years (2028), as the baseline. Over the 11-year period 2018-2028 the profit and loss account improvement over baseline is £4.08m (after taking into account incremental States of Guernsey Guarantee fee of £2.2m) – refer to Table 2 below. The cash balance at the end of the period is £0.6m better than baseline.

	£000s
Maintenance Costs - saving from new aircraft	15,976
Delay & Disruption and EU261 costs saving - improved reliability	1,695
Credit memos for Services	333
Additional Depreciation & Interest cost, less lease cost savings	(10,853)
Additional Insurance cost	(343)
Transition Costs	(575)
Book loss on sale of owned ATR72-500s (G-COBO & G-VZON)	(456)
Interest on pre-delivery deposit payments	(245)
Loan arrangement fee	(343)
	5,189
Reduction in Delay & Disruption and EU261 costs - Clearvision	1,100
Improvement in Profit & Loss versus Baseline	6,289
States of Guernsey Guarantee fee cost	(2,206)
Improvement in Profit & Loss after SoG Guarantee fee cost	4,082

Table 2. Profit & Loss improvement over baseline 2018-2028

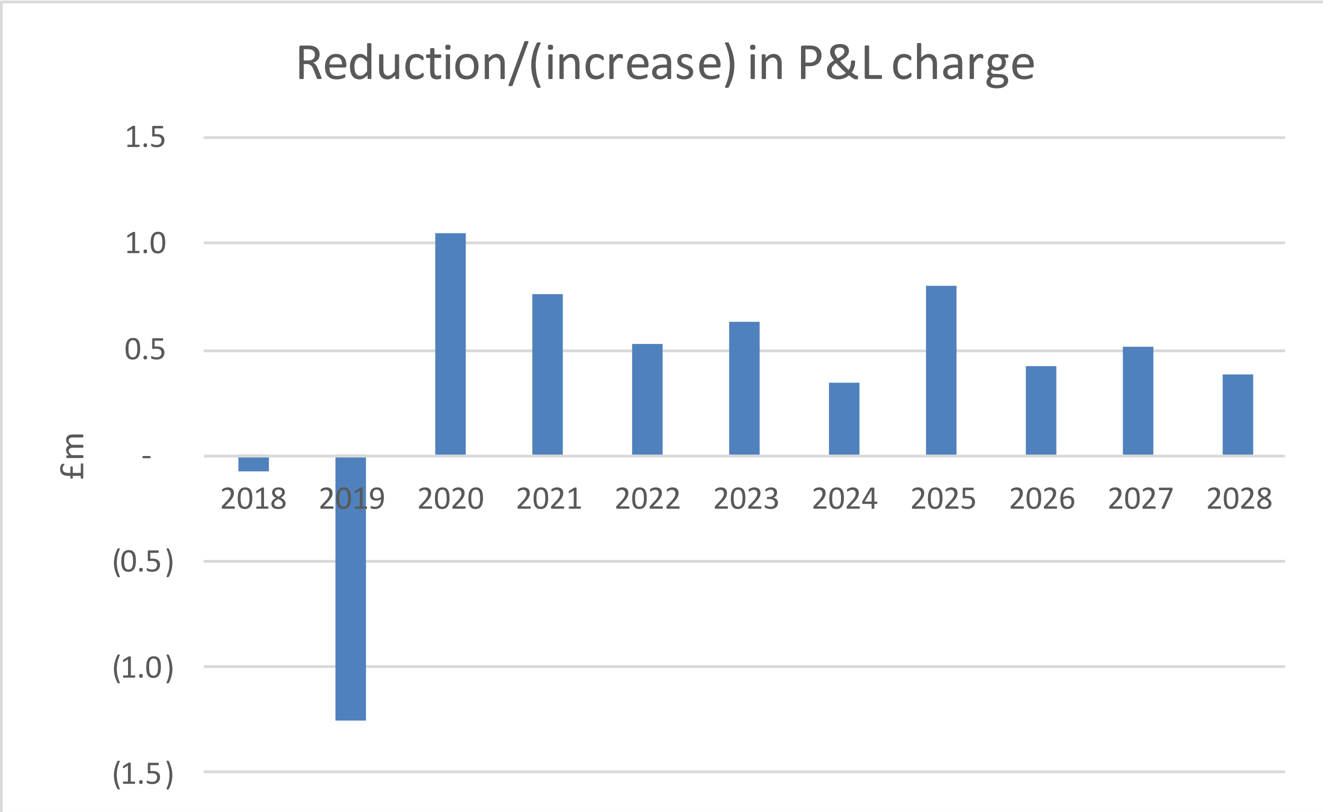

Figure 6. P&L charge following introduction of the ATR 72-600 fleet in 2019

The large negative P&L impact in 2019 is due to a number of one-off transition costs including loan arrangements fees (£340k), delivery costs on sale of the owned aircraft (e.g. painting back to white) (£250k), and the loss on sale of the owned aircraft (£450k). Note that we have assumed the aircraft will not sell on the open market, so we have assumed "worst case" and that ATR would need to be used as a "buyer of last resort". The impact of this is the application of $500k discount to ATR's market valuation of the aircraft. It's possible that accountancy rules will require some of the losses projected for 2019 to be recognised in 2018.

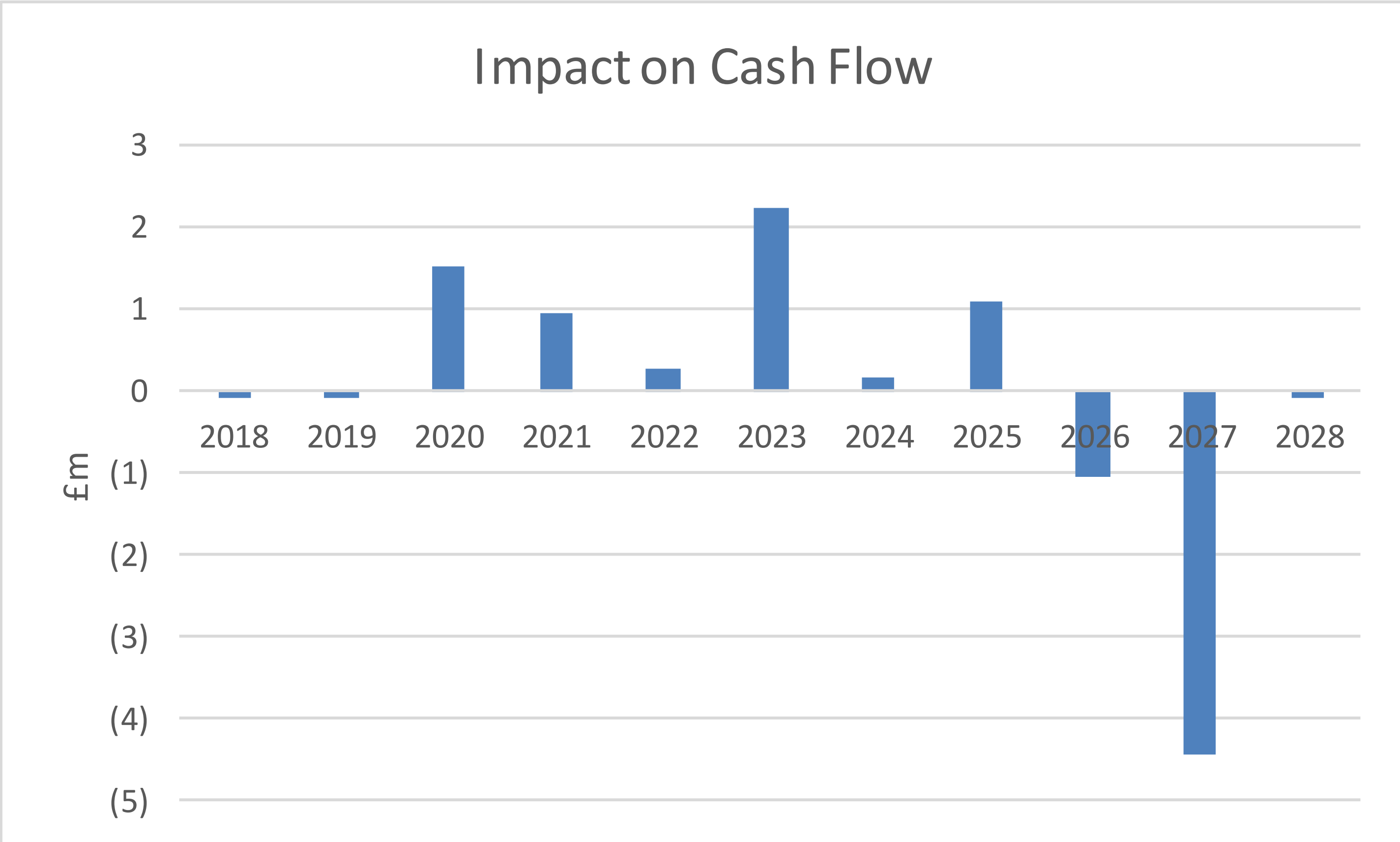

Figure 7 Cash flow impact of the introduction of the ATR 72-600 fleet in 2019

The negative cashflow impact in 2026 and, particularly, 2027 is due to the first full engine and undercarriage overhauls on the ATR 72-600s taking place. The equivalent overhauls for the ATR 72-500s fall due in 2023, but the positive impact is reduced by the fact that Aurigny only has to bear the overhaul costs for 2 aircraft in the base case as the third aircraft is leased, therefore major overhauls will be covered by the maintenance reserve

6.2.2. **P&L Adjustments - notes**

i. Maintenance Cost

Aurigny has extensive experience of the ATR 72 having operated this type of aircraft since 2003, including a 19 year-old model sold in 2016. Based on this experience, and manufacturer data, costs of maintaining ATR 72-500 aircraft with age 10 to 20 years have been forecasted. To reflect the cost/risk to the P&L forecast of operating ageing aircraft, a provision of £2.5m has been made for unplanned events including: corrosion (remediation which has been a feature resulting from environment); engine repairs arising from high accumulated hours/cycles; and wear and tear on components.

A secondary, but important, benefit of acquiring new aircraft is that it should give greater certainty over maintenance cost projections. The cost of maintaining new ATR 72-600 aircraft in the first 10 years of life has been forecast using manufacturer data that has been adjusted for the specific environmental conditions in which the aircraft will be operating. This adjustment has been made by Aurigny's engineering department based on experience with the existing aircraft. Manufacturers' warranty of 4 years has been negotiated into ATR's offer (normal is 3 years) which mitigates cost.

The forecast saving in cost is £16.0m.

ii. Additional Depreciation & Finance costs, less lease cost saving

There are 3 ATR 72-500 aircraft in the current fleet, 2 owned and 1 leased. The proposal is to replace these with 3 owned ATR 72-600s. The indicative funding offer from [redacted] has been used as the basis of the model. Net additional cost is forecast to be £[redacted]m.

iii. Additional insurance cost

The value of the ATR 72-600s will be greater than the existing aircraft hence higher premiums.

iv. ATR Credit memos for services

Credit memos may be used for services/aircraft parts purchased from ATR or as discounts off the purchase price.

v. Transition Costs

The improvement summarised above is after taking account of transition costs. Within our model we have included a comprehensive allowance for transition costs (loan arrangement fees, interest on pre-delivery deposits, legal fees, pilot and engineer training, contractor pilots to cover for our pilots while they undergo training, removing airline markings from sold and off-lease aircraft, etc).

ATR will provide pilot and engineer conversion training within the purchase price under the terms of the Heads of Agreement.

vi. Sale of current 2 owned ATR 72-500s

We have taken a conservative approach to the impact of the sale of these aircraft in our model. ATR has modelled the condition of the aircraft now and in mid-2019 using their in-house methodology. Their estimate is that the aircraft will be worth $[redacted]) each in mid-2019. Their offer includes a 'buyer of last resort' clause to purchase the aircraft for $[redacted]) each. An estimated cash surplus of c.$[redacted]m is anticipated on sale of these aircraft once the existing financing (NatWest) is repaid. Our model assumes this surplus will be re-invested in the new aircraft.

The book value of the aircraft is forecast at £[redacted]m in July 2019. Set against the likely proceeds of 2 x £[redacted]m described above, the forecast 'loss on sale' is £0.[redacted]m – this has been incorporated into the model.

vii. Reduction in Delay & Disruption Costs and EU261 Costs - reliability

Not only do aircraft out of service due to maintenance unserviceability result in loss of reputation, but also trigger EU261 compensation payments for delays and 'duty of care' costs resulting from flight delays and cancellations.

Such delays are classified as 'inexcusable' for EU261 compensation payments in cases where a flight cancellation or delay in excess of 3 hours is incurred. Over 10 years the saving in these costs is estimated to be £1.695m.

viii. Reduction in Delay & Disruption Costs and EU261 Costs – Clearvision

Clearvision will reduce the number of occasions where flight cancellations or delays trigger passenger 'duty of care' payments. Additionally, by reducing the number of reactionary delay events after foggy weather (which are classified as 'inexcusable') EU261 payments can be reduced. Over 10 years the saving in these costs is estimated to be £1.1m.

ix. Delivery of ATR 72-500s to ATR

In the event that the currently owned ATR 72-500s are sold to ATR, they will need to meet delivery conditions. These have been fully assessed the costs incorporated into the financial modelling. See Appendix .

6.2.3. Asset finance

Offers have been obtained from 3 prospective financing parties: the ‘with formal capital guarantee from States of Guernsey’ offer from [redacted] has been used for modelling. Key terms are:

- Written indicative quote [redacted]
- Facility - £[redacted]m
- Commitment period - 10 years from drawdown
- Amortisation profile - to reduce to £[redacted]m within the Commitment Period
- Security - States of Guernsey guarantee (cost of fee has been assumed as [0.8% per annum])
- Interest – 10-year fixed rate [redacted]% (via interest rate swap mechanism) [redacted])
- Margin – [redacted] bps
- Arrangement fee – [redacted] bps
- Early repayment fee – n/a
- Security (mortgage) against aircraft assets – no
- Repayments – capital and interest repayments quarterly
- Pre-delivery payments funding facility for up to £5.5m to be available on similar financing terms

Without a formal capital guarantee from the States of Guernsey, the margin offered increases to [redacted] and the Arrangement Fee from [redacted]bps to [redacted] bps.

6.2.4. Pre-delivery payments to ATR

ATR's terms for payment of the aircraft include:

- $200,000 on signature of Heads of Agreement (Note: these have already been paid but are refundable in the event that the decision is made not to proceed.)
- 5% 18 months before delivery
- 5% 12 months before delivery
- 5% 6 months before delivery

[redacted] has indicated that it is able to fund these pre-delivery payments which amount to approx. £5m. Indicative terms have been used in the model.

6.2.5. Cash Impact

The cash impact is an improvement of £0.6m across 10 years compared with Base Case. Divergences from Base Case are assessed as manageable.

Key assumptions underpinning the business plan model are:

- GBP:USD exchange rate throughout - $1.35 (apart from on the Aircraft Purchase, where a rate of $1.325 has been used as we know this rate could be obtained now)
- GBP:EUR exchange rate throughout – Euro 1.15
- Asset finance – indicative offer from [redacted] (see above)
- Asset base cost $[redacted]m expressed in July 2018 terms plus [redacted]% Escalation with Clearvision™ installed
- Credit memos $[redacted] per aircraft and $[redacted]k worth of training credits.
- Price after Escalation $[redacted].
- Cash surplus realised on sale of G-COBO and G-VZON is c. $4.3m which sum is re-invested in the acquisition
- The ATR 72-500 currently on lease [redacted] (G-LERE) until November 2021 will be sub-leased. ATR will contribute up to $[redacted],000 per month to offset any short-fall, which is expected to be between £250k-£300k annually in 2020 and 2021. This remaining shortfall, which equates to around $27k per month, will be need to be made up by Aurigny.
- Refinancing of existing ATR 72-500 aircraft in event of 'do nothing' will be on indicative terms from [redacted] - similar to the offer for new aircraft except margin would be [redacted]bps, the arrangement fee [redacted]bps and the £8m capital paid down to £4m over 5 years.
- Depreciation of existing ATR 72-500 – consistent with existing Accounting Policy

- Depreciation of new ATR 72-600 aircraft – consistent with existing Accounting Policy
- ATR maintenance costs have been provided by ATR and adjusted by Aurigny's engineering management to reflect specific environmental conditions.

6.3. Sensitivity Analysis

The sensitivity to changes in the various assumptions that have been used in the preparation of this business case have be assessed below:

Sensitivity Analysis		£000s
Maintenance - ATR72-500 Effect of 1% movement	Spare parts	180
	Structural checks & mods	36
	Engines	82
	Propellers & undercarriage	36
	Lessor Reserves	68
	Unscheduled events & refurbs	28
		429
Maintenance - ATR72-600 Effect of 1% movement	Spare Parts	111
	Structural checks & mods	22
	Engines	101
	Propellers & undercarriage	26
	Lessor Reserves	10
	Unscheduled events & refurbs	-
		270
Clearvision Benefits	Effect of 10% overestimate of clearvision benefit	110
ATR72-600 residual value	Effect of ATR72-600 being sold after 10 years for 95% of NBV	924

		£000s
GBP:USD exchange rate	Effect of movement of 5 cents from forecast value of 1.35	254
Sublease income from leased ATR72-500	Effect of 10% movement in achieved sublease income	89
Renewal of lease for leased ATR72-500	Effect of 5% movement in rate achieved on renewal of ATR72-500 lease	239
Additional delay & disruption payments	Effect of 10% movement in additional delay & disruption costs (including subcharter costs) incurred as a result of continuing with the Base Case - 3 ATR72-500s	170
Increase in interest rate or margin	Effect of a 0.15% increase in either of interest rate or financing margin	400

7. Management Case

7.1. Project Management Arrangements

Aurigny has a well-developed 'Management of Change' process as part of its management system as agreed with the CAA.

Should this project be given permission to proceed, a project manager will be appointed. Depending on what other projects are likely to be on-going we may use an external resource to manage the ATR 72-600 introduction (or take-over other projects to release the project manager for this project). The cost of an external resource has been provided for in transition costs. In addition, we may need use to external resources to manage the delivery of the two currently owned ATR 72-500s to be delivered to ATR and to make sure that the aircraft are delivered in accordance with the delivery conditions (see Appendix). We have already engaged a consultant to produce technical records 'bibles' for the two owned ATRs to facilitate the transfer process. This has now been completed so all that will be required is an update at the time of sale.

Key elements that will need to be effectively managed include:

Project Element	**Resources**
Project management	Project Manager
Negotiating the final purchase agreement	Exec Management and Specialist Aviation Lawyer
Negotiate final specification	Exec Management
Negotiating financing	Executive Management and Lawyer
Pilot Training – differences course	ATR

Engineer – differences course	ATR
ATR 72-500 Delivery to ATR • Tech records 'bible' • Predelivery checks • Aircraft painting (white)	• Consultant • Third Party Maintenance Organisation • Third party paint organisation
Spares procurement PTT spares/disposal of redundant stock	Aurigny procurement
Manuals – changes	Aurigny flight operations
Spares support agreement	Negotiate
ATR 72-600 Inspection and acceptance	Aurigny Technical Director and team

7.2. Benefit realisation – Fleet transition

The change from the existing ATR 72-500 fleet to a new ATR 72-600 fleet is a relatively uncomplicated project as the ATR-600 is a very similar aircraft with the major differences being concentrated in the flight-deck systems.

Flight crew will require a 5 day differences course to convert to the new model followed by a modest amount of consolidation line training. Following this training, crew will be able to operate either the ATR-500 or ATR-600 provided any change of model during a duty is preceded by a suitable re-briefing time period.

In addition, it is expected that a short additional course would be required to qualify crew to use the ClearVision system.

Crew conversion and ClearVision courses will be provided by ATR with Aurigny responsible for crew travel and accommodation. Based on the training timeframes, an additional crew will be required for the transition period including a Type rated examiner. This is expected to cost £200k.

Engineers do not require significant retraining but will be provided with courses to cover major system differences (mainly avionics) as part of the transition programme. This training is included in ATR’s offer.

Spares investment will be required to support the new avionics systems on the ATR 72-600 but much of the current spares holding remains useable. An investment of up to $600k is forecast but as the company uses a maintenance support contract with Sabena for ATR rotable components it is expected that the new aircraft can be included in the existing agreement and therefore this investment will not be required. Alternatively, it would be possible to use ATR’s credits to fund the additional spares.

The disposal of the two owned ATR 72-500 aircraft will take place two months after the delivery of the first and second new aircraft. This will allow sufficient time for any maintenance /painting that is required to meet delivery conditions.

During the negotiation of the purchase or lease agreement Aurigny will require legal support. Based on previous transactions we have budgeted £15,000 to cover legal expenses.

7.3. Contracting with ATR

7.3.1. Terms and Conditions

Aurigny has negotiated a non-binding 'Letter of Intent'. The LOI is comprehensive and covers the key commercial terms.

The Letter of Intent is included as Appendix 2.

7.3.2. Finalising the Contract

Once it is agreed that the project is to proceed we will engage a specialist aviation lawyer to advise the Aurigny Board on the contract. The costs of using a lawyer have been provided for in the financial model.

7.4. Key Risks

The key risks associated with this project are detailed in Table 3 below. Financial implications applicable to these risks are covered by contingency budgets included in the current Programme Risk Register.

Ref.	Risk	Likelihood	Impact	Risk Score	Mitigation Measures
Risk 1	Inability to use Clearvision	2	2	4	ATR has agreed a schedule of liquidated damages in event Clearvision is not available in circumstances where weather minima are below thresholds – capped at $[redacted]k per aircraft. Failure to deliver the aircraft would be an inexcusable delay under the terms of the contract and delivery could be delayed until they could deliver the aircraft with Clearvision functioning.
Risk 2	Failure of new components	2	1	2	ATR has agreed to provide a [redacted] Warranty [redacted]) for parts
Risk 3	Unable to sub-lease existing leased ATR 72-500 (G-LERE)	2	2	4	ATR has agreed to contribute up to [redacted] per month to offset shortfall in lease rate in event this aircraft is sub-leased at a rate below Aurigny's obligation to the lessor (LEASING CO. #1). In addition, the financial model has assumed that Aurigny will need to contribute a further £25k/month to subsidise the lease rate. We are reasonably certain that it should be possible to sub-lease the aircraft at less than $[redacted]k/month.
Risk 4	Unable to sell 2 existing owned ATR 72-500s	1	1	1	ATR will act as purchaser of last resort guaranteeing to buy back the aircraft
Risk 5	Adverse movement in Interest Rates	3	2	5	Risk is unmitigated until contracts are signed following which it is envisaged fixed rate swap arrangements will be put in place with the financing party. Therefore, the interest rate that will apply will be certain before finally committing to the transaction.

Risk 6	Adverse movement in US$ - GBP exchange rate	5	2	10	Risk is unmitigated until contracts are signed following which it is envisaged currency swap arrangements will be put in place with the financing party. Therefore, the exchange rate that will apply will be certain before finally committing to the transaction.
Risk 8	Delayed delivery of new aircraft	2	2	4	Delayed delivery of the aircraft (up to 6 months) will have limited effect as the contract will permit us to retain the old/owned ATR 72-500s until delivery has taken place. The final purchase agreement will reflect this. The sub-leasing of the LEASING CO. #1 leased aircraft is unlikely to be committed to until after the first new aircraft has been delivered.

Table 3. Summary of key project risks

The above risk matrix is based on a 5 x 5 matrix, where: Likelihood: 5 = Certain, 1 = rare occurrence; Severity: 5 = catastrophic, 1 = little impact. So a risk score of 25 would be completely uLEASING CO. #1ceptable and would have to be mitigated whereas as score of 1 would be of little consequence.

Appendices

Appendix 1 - Glossary of Terms

ATR 72-500	A short haul, regional airliner developed and certified in January 1997 by ATR, a turbo-prop aircraft manufacturer based in Toulouse, France.
ATR 72-600	A regional airliner with different, enhanced equipment fitted in comparison to ATR 72-500, with various improvements, first certified in 2009.
Clearvision	System designed for low visibility and night conditions offering optimised head-up capabilities, enhanced and synthetic vision.
Decision height	A specific height or altitude, at which a missed approach must be initiated if required visual reference has not been established.
Dispatch Reliability	Ability to send the aircraft into passenger service under compliance of all safety regulations.
EASA	European Aviation Safety Agency. EASA is the main body within the European Union responsible for civil aviation safety.
Energy Aviation	Consultancy based in Leeds offering focussed advisory services to the regional aviation community.
EU-261	EU-261 of 2004 is the underlying regulation of EU passengers' rights in terms of liability of an airline when incurring severe delays of cancellations.
Glass Cockpit	A term given to aircraft, where the primary flight instruments of the flight deck are located within one display, typically an LCD screen.
LEASING CO. #1	[redacted]. LEASING CO. #1 provides lease and lease management services to airlines worldwide.
Operating Leases	A contract that allows for the use of an asset but does not convey the right of ownership over the asset.

RVR	**Runway Visual Range, the distance of which a pilot located on the centreline of a runway can visually identify the centreline.**
Seat pitch	**The distance between a point on a seat and the exact same point on the seat behind it.**
Slim-backed seats	**Slimline seats offer enhanced legroom and passenger comfort, while the number of seats remains in an economic configuration.**
Soft Market	**More potential sellers than buyers present in the market.**
STSB	**States' Trading and Supervisory Board**

Appendix 2 - Financial model

REDACTED FOR REASONS OF COMMERCIAL CONFIDENTIALITY

Appendix 3 – Offers received to lease or purchase aircraft

REDACTED FOR REASONS OF COMMERCIAL CONFIDENTIALITY

DATE	3RD PARTY	LEASE	PURCHASE	FINANCE LEASE	SUMMARY OF KEY TERMS/CHANGES TO EARLIER VERSION
04/04/17	[redacted]		X		Purchase price [redacted] Delivery dates: [redacted] No. aircraft offered?: [redacted] New aircraft [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted] Other:
19/01/18	[redacted]	X			Rental p.c.m.: [redacted] Lease term: [redacted] No. of aircraft?: [redacted] New aircraft? [redacted] Reserves/Month: [redacted] Delivery: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted]
05/02/18	[redacted]	X			Rental p.c.m.: [redacted] Lease term: [redacted] No. of aircraft?: [redacted] New aircraft? [redacted] Reserves/Month: [redacted] Delivery: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted] Support for leased aircraft?: [redacted]

					Clearvision?: [redacted]
DATE	[redacted]	**LEASE**	**PURCHASE**	**FINANCE LEASE**	[redacted]
08/02/18	[redacted]	X			Rental p.c.m.: [redacted] Lease term: [redacted] No. of aircraft?: [redacted] New aircraft? [redacted] Reserves/Month: [redacted] Delivery: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted]
27/03/18	[redacted]	X			Rental p.c.m.: [redacted] Lease term: [redacted] No. of aircraft?: [redacted] New aircraft? [redacted] Reserves/Month: [redacted] Delivery: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted]
30/03/18	[redacted]		X		[redacted]
12/04/18	[redacted]		X		[redacted]
20/04/18	[redacted]		X		Purchase price [redacted] Delivery dates: [redacted] No. aircraft offered?: [redacted] New aircraft [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted] Warranties: [redacted]

					Buy-back of -500s?: [redacted]
Date	[redacted]	**Lease**	**Purchase**	**Finance Lease**	[redacted]
01/05/18	[redacted]		X		Purchase price [redacted] Delivery dates: [redacted] No. aircraft offered?: [redacted] New aircraft [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted]
14/05/18	[redacted]			x	Financing terms [redacted] Delivery dates: No. aircraft offered?: New aircraft Support for leased aircraft?: Clearvision?: Warranties: Buy-back of -500s?:
15/05/18	[redacted] [redacted]		X		Purchase price: [redacted] Delivery dates: No. aircraft offered?: New aircraft Support for leased aircraft?: Clearvision?: Warranties: Buy-back of -500s?: Other:

DATE	[redacted]	LEASE	PURCHASE	FINANCE LEASE	[redacted]
16/05/18	[redacted]		X		[redacted]
31/05/18	[redacted]		X		Purchase price [redacted] Delivery dates: [redacted] No. aircraft offered?: [redacted] New aircraft [redacted] Support for leased aircraft?: [redacted] Clearvision?: [redacted] Warranties: [redacted] Buy-back of -500s?: [redacted]
01/06/18	[redacted]		X		[redacted]
29/06/18	[redacted]		X		[redacted] [redacted]

ATR LETTER OF INTENT

June 2018

REDACTED FOR REASONS OF COMMERCIAL CONFIDENTIALITY

Appendix 5 - Delivery conditions for ATR 72-500

ATR Requirement	G - COBO	G - VZON	Rectification action required	Cost
Airworthy	Airworthy	Airworthy	N/A	0
Free and clear of any operational liens	Yes	Yes	N/A	0
Eligible for coverage under a certificate of airworthiness for export	Yes	Yes	N/A	0
Clean and serviceable by airline international standards	Yes	Yes	N/A	0
Recently painted white with existing painting sanded up to primer coating	Needs repaint prior to delivery	Needs repaint prior to delivery	Arrange for aircraft to be painted at suitable facility	30,000 (off-peak) - 40,000 (peak) , depending on date required
Without any deferred maintenance or waivers	Yes	Yes	N/A	0
In compliance with all manufacturer's mandatory notes and mandatory Services Bulletins and with all Airworthiness Directives issued by the EASA with a compliance date falling no later than six months after the date of redelivery	Yes	Yes	N/A	0

Equipped either B-RNAV compliant GPS system coupled with EFIS. ACAS change 7 system. EGWS system, EASA compliant CVR and DFDR, FM immunity capability, 8.33KHz VHF channel spacing capability, elementary surveillance capability and enhanced surveillance capability	Yes	Yes	N/A	0
Bridged to the manufacturer block maintenance program as defined in the last issue of the Maintenance Planning Document for the type and clear from any airframe inspection for a period of 18 months and/or 3000 cycles and/or hours	Already on the programme	Already on programme	None if delivery is on schedule, severe delays may trigger airframe inspection	0
In a condition that each engine shall have no more than 1500 flight hours and cycles accumulated since the last Hot Section Inspection	A H.S.I on both engines will be required prior to re-delivery to ATR. Each engine will not have accumulated significant flying between H.S.I and sale. This has been scheduled and accounted for on both G-COBO and G-VZON		H.S.I to be completed before sale	Cost of H.S.I - £500,000 per engine. This cost has been accounted for.
In a condition that each engine shall be delivered in good condition, airworthy, serviceable and without limitation below 1500 flights hours other than the borescope inspection required for all on-condition PWC127 series engines	On condition, except prop maintenance outlined in prop section		N/A	0
With engines life limited parts located in the hot section (including HP blades) having a minimum of cycles remaining equal to 6000 cycles less the number of flight hours elapsed since the Hot Section Inspection	Will comply	Will comply	N/A	0

In a condition such that each engine shall have no more than 7500 flights hours and cycles accumulated since the last Overhaul. However, when Buyer will perform next Hot Section Inspection on any engine fitted on any Used ATR 72-500 prior to its respective Used ATR 72-500 Redelivery Date. Seller will have the right to elect to either let the Buyer proceed with the Hot Section Inspection or request buyer to proceed with a full engine Overhaul and bear the costs of the Cold Section Inspection and RGB Overhaul	All engines meet the return conditions for September and November 2019. The deadlines for reaching 7500 flight hours and cycles since the overhaul is as follows: **G-COBO (left) - Jan2020** **G-COBO (right) - May2020** **G-VZON (left) - May2020** **G-VZON (right) - Aug2020**		N/A	0
With engine life limited parts located in the cold section having a minimum of cycles remaining equal to 12000 cycles less the number of flight hours elapsed since the last overhaul	Life limited parts meet the return conditions ATR in September and November 2019.		N/A	0
With propellers having not less than 3000 flight hours remaining to the next scheduled overhaul	3 prop blades have less than 3000 hours remaining at point of sale. Another 4 blades may require a repair prior to re-delivery. Both prop hubs, actuators and oil tx tubes have less than 3000 hours remaining.		New blades (switch blades), hubs and actuators	Blade overhaul ~ £35,000 Blade repair ~ £10,000
With landing gears having not less than 3000 cycles or 18 months remaining to the next scheduled overhaul	Will comply – overhauled in 2018	Will comply – overhauled in 2018	N/A	0

With all other life-limited and hard-time components being in not less than half-time or half-life status	Life-limited components in the cabin, which require replacement prior to delivery. 897940-77 OXY BOTTLE 863521-01 FIRE EXTING* 863521-01 FIRE EXTING* 863521-01 FIRE EXTING* E28180-20-0001 SMOKE HOOD MC10-04-105 MASK ASSY R* MC10-04-105 MASK ASSY R* MC10-04-110 MASK * MXP601 OXY BOX * MXP601 OXY BOX * MXP601 OXY BOX * RCF6709 REGULATOR * 472420-2 FIRE BOTTLE*		Must be changed and renewed prior to re-delivery or re-negotiated (small items only)	
With all on-condition classified components being fully serviceable at redelivery	Yes	Yes	N/A	0
With all main elements such as engines, landing gear and propellers serviced by an OEM approved MRO and provided with their appropriate documentation	Provided	Provided	N/A	0
With all serialized components provided with their documentation	Yes	Yes	N/A	0
With all modifications that are not covered by a manufacturer Service Bulletin (including but not limited to STC's) being agreed by the new owner or removed by Buyer prior to each redelivery	No sig. modifications	No sig. modifications	N/A	0

In compliance with all manufacturer's corrosion prevention and control program requirements and with all CPCP inspections which would normally be accomplished while access is provided during structural inspection in accordance with the Maintenance Program having been accomplished	Will comply	Will comply	N/A	0
With fuel tanks free from contamination and corrosion and with a tank treatment program in operation	Will comply	Will comply	N/A	0
With approved release to service certification for Hard-Time and On-Condition serialized components	Will comply	Will comply	N/A	0
With the technical and operation publications, accurate and fully updated	Will comply	Will comply	N/A	0
With the aircraft, engines and propellers records and data, in particular the engine data enabling the adequate engine trend monitoring and aircraft status.	Will comply	Will comply	N/A	0

<u>Conclusion</u>

Both G-COBO and G-VZON will undergo a Hot Section Inspection prior to sale, which has been accounted for by Aurigny. Resulting from the H.S.I, all four engines will be on-condition and recently maintained at the time of delivery. The highest costs will be any prop blade repairs and the full painting of the aircraft. These have been provided for in the financial model. Minor costs include the replacement of fire extinguishers and other minor life-limited components in the cabin. In all other areas, both aircraft will meet ATR's requirements.

Appendix 6 - Usage of back-up ATR

Introduction

This analysis, based on the period 01/01/17 to 31/7/18, seeks to examine the usage of ATR 72-500 backup aircraft within the day-to-day operation of Aurigny scheduled passenger services. It is sought to find out, whether the possession of two (2) ATR 72 aircraft are sufficient to fulfil the flying program set out in the examined period above. As established in sections 1.0 and 1.1, current requirements and usage of the 3rd backup aircraft is shown and the daily operational reasons for doing so. In addition, the report outlines the cost in additional sector cancellation and delay, when only 2 aircraft are used during this historical period (section 2.0-4.0).

1.0 Current Aircraft Requirements

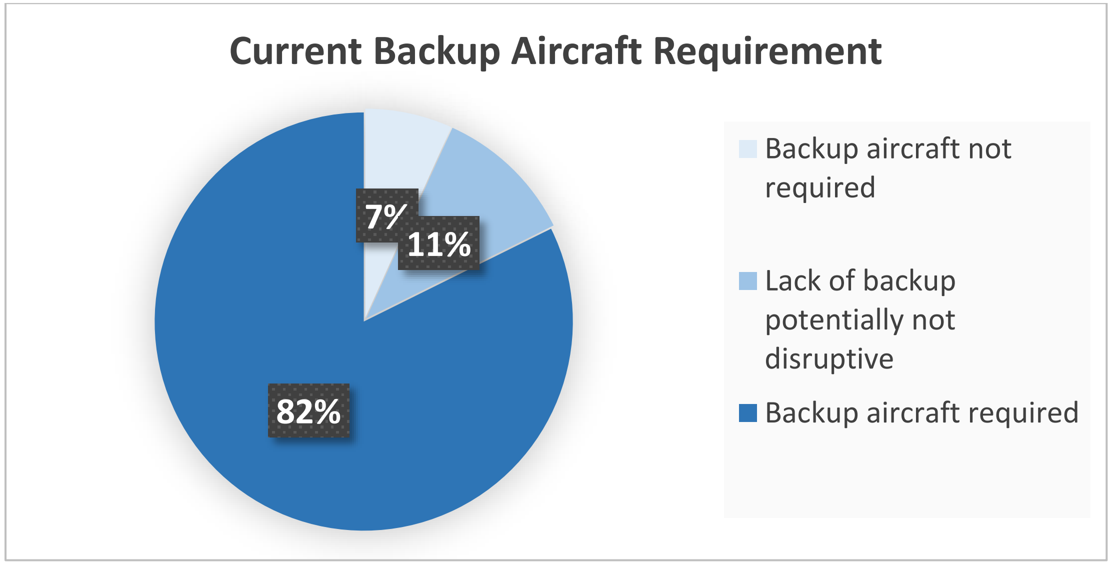

Figure 8: Backup ATR Requirement

Figure 1 depicts the usage of the 3rd ATR aircraft (backup). Only on 7% of the days, no backup aircraft was required nor utilised by Aurigny. Within the examined period this aircraft has been utilised by Aurigny on 93% of the days. On 82% of the analysed days the backup aircraft was in service to prevent disruption following up from a previous event (reasons outlined in 1.1). On few occasions (11%), the backup was utilised for convenience/aircraft rotation, but the lack thereof would have potentially not resulted in any sort of disruption.

1.1 Reasons for Current Backup Requirements

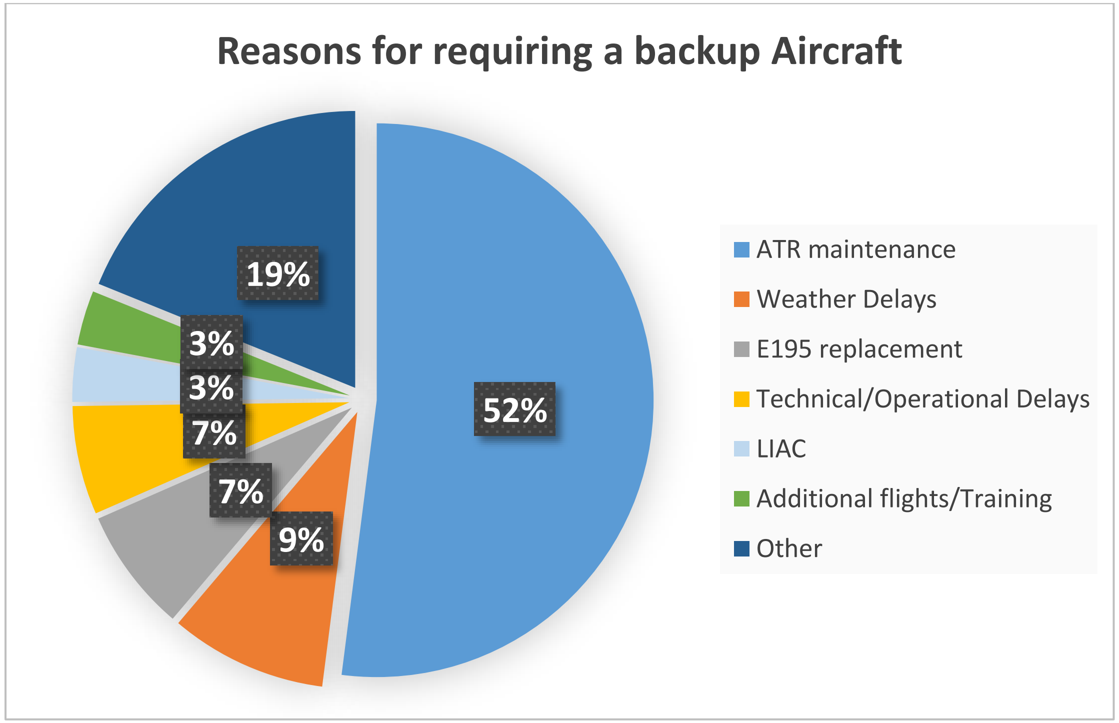

Figure 9: Reasons for a backup Requirement

Outlined in Figure 2 are the various reasons for requiring a backup aircraft within the examined period. A clear majority of 52% is triggered by maintenance on the ATR aircraft. Whether scheduled or reactive, maintenance may ground an aircraft for a time of a few hours to a few days. Larger calendar checks on aircraft may take up several days, where the aircraft is not serviceable for commercial flights. Without a backup aircraft, scheduled flights would need to be completed with one ATR only for half the amount of days in the examined period. 9% of the days were affected by poor weather, which brought delays, diversions and inabilities to take-off and land to the flight schedule. There is a tendency for disruption to latch onto consecutive days, when no backup aircraft is utilised. Technical delays and minor faults in aircraft operation triggered the backup requirement on 7% of the days to reduce vulnerability to knock-on delays. On a further 7% of days the ATR fleet was utilised to replace Embraer E195 services, following a technical fault or scheduled maintenance on this aircraft. This proves essential to provide adequate reliability on the Guernsey to London Gatwick route, without compromising any of the scheduled ATR routes and booked passengers.

2.0 Additional Cancellations

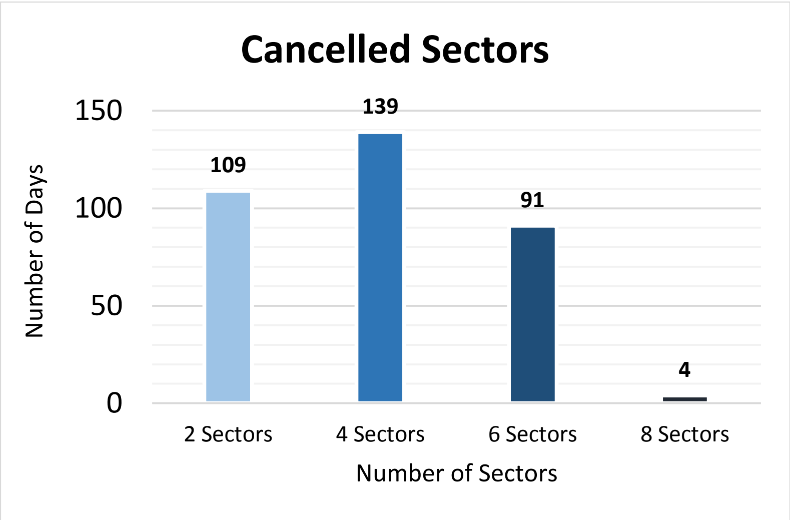

Figure 10: Cancelled Sectors when only 2 ATR Aircraft available

Should the examined period need to be completed using only 2 (2) available ATR 72 aircraft, a significant number of services require to be cancelled as the flying program fails to be completed in times of disruption. Out of 577 days, 343 days of scheduled passenger flights require the cancellation of 1 or more sectors following one of the events outlined in section 1.1. This represents 59.4% of the examined timeframe. Figure 3 shows the number of sectors required to be cancelled each day. A total of 1351 sectors would have to be cancelled, following a failure to provide the service due to a lack of capacity in terms of ATR aircraft.

The cancellations would affect an approximate of 65,000 passengers, assuming a historic load factor of 48 passengers in an ATR 72 (67%). A large proportion of these cancelled sectors would be liable to EU-261 compensation, or in any case a pay-out for passengers to reach their intended destination with Aurigny, hotel or convenience arrangements. Cancellation of these sectors creates a liability of minimum £7.1million in EU-261 compensation and further travel arrangements.

3.0 Additional Delays

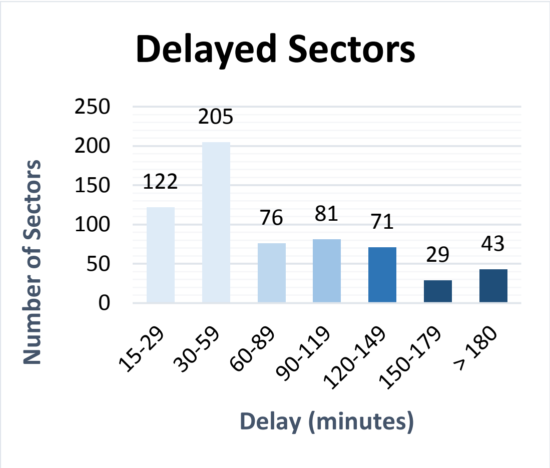

Figure 11: Delayed Sectors when only 2 ATR Aircraft available

A lack of a backup aircraft causes several additional delays to the flight schedule. 226 days of the examined period would be affected by 1 or more delayed sectors as a result of not being able to utilise a 3rd ATR, which is 39.2%. This in effect creates 627 additionally delayed sectors, most of which (205) are in the category of 30-59min delayed. Overall, there is an increase in severe delays (120+ min) by 3%, adding to Auringy's liability to pay EU-261 compensation and other pay-outs for passenger convenience during such a delay. 143 out of the 627 sectors additionally delayed can be considered as a severe delay. It creates a liability of approximately £450k.

3.1 Knock-On Delays - Example

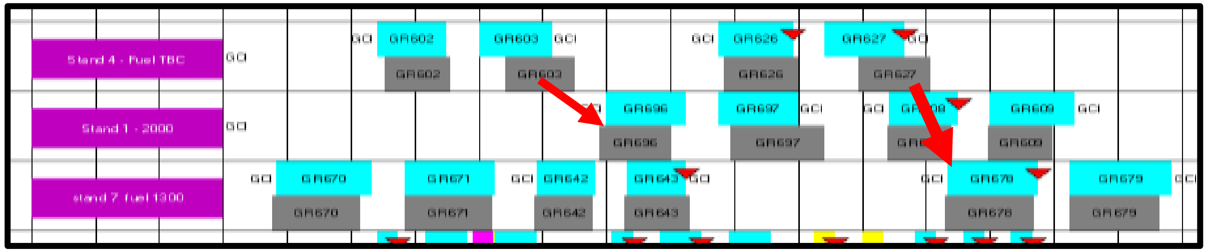

Figure 12: Worked Example Knock-On Delay

- GR603 / GR627 show a tendency to develop minor 15-30min delays due to ATC at

Day-to-day operations are scheduled carefully to minimise turnaround times and maximise aircraft utilisation during Guernsey Airport opening hours. A vulnerability towards knock-on delays is created, as little delays (<30min) may have a significant impact on the timeliness of the aircraft over the entire day. A knock-on delay exaggeration would occur on 10 days of the examined period, should the backup not be available.

In Figure 5, the operational would have to be completed within two lines of flying. GR603 and GR627 were delayed 33.4% of the analysed period by a time of 20min or more. This is due to ATC restrictions and slot given on GR603 and issues concerning ground handling on GR627. Without a backup aircraft this decreases the turnaround times from GR603/627 onto their consecutive next flights to under 25min, a timeframe with which ground handling struggles to complete on time. The result is knock-on delay carried throughout the and the possibility of an out-of-hours arrival into Guernsey Airport for the last flight of the day.

4.0 Late Arrivals at Guernsey Airport

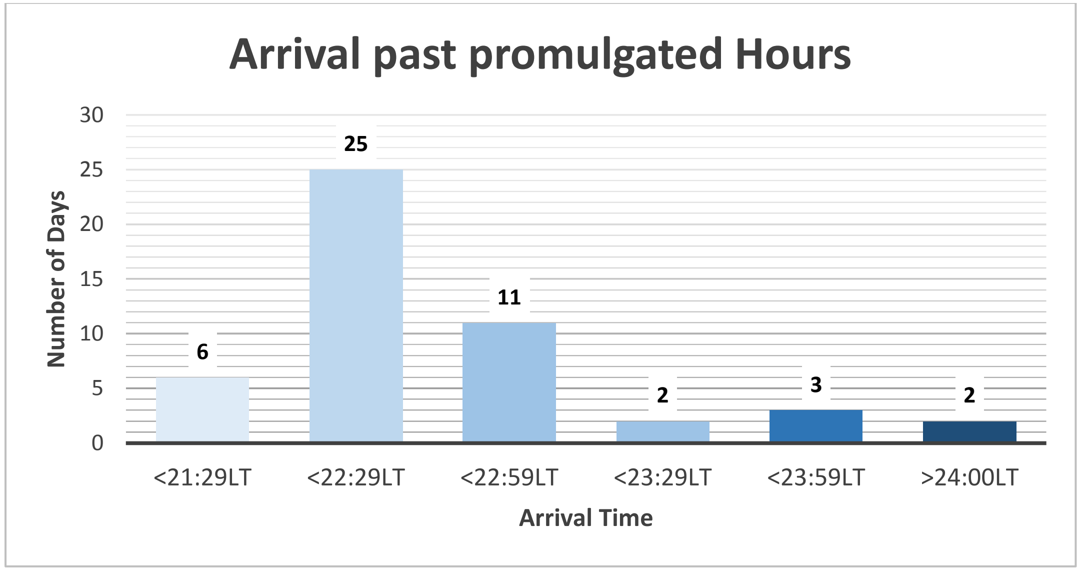

Figure 13: Arrival past Guernsey Airport Hours

Guernsey Airport publishes opening hours, at which the last landing is supposed to occur no later than 21:00LT. Delays caused by the lack of a backup aircraft may impact the ability for the last flights of the day (e.g GR679) to arrive within the promulgated hours. Without utilising a backup ATR, Aurigny would not be able to arrive on-time at night for an additional 57 days (9.9%). There is a liability to Aurigny in fees payable to Guernsey Airport of approximately £70,600 to use the facilities outside the published hours. Continuous late arrivals would have severe implication for Guernsey ATC, who will be required to stay working past 21:30LT, awaiting late inbound aircraft. Alternatively, aircraft will be stuck "away from base", causing implications the following morning to scheduled services.

Appendix 7 - Delay and Disruption Costs

1.0 Introduction

A disruption to scheduled passenger services may result in liability towards compensation and costs incurred in re-arranging travel for affected passengers. Delays or cancellations are the consequence of poor weather and/or technical events on the aircraft amongst other reasons. Guernsey is located in a maritime environment, particularly vulnerable to fog and wet weather following-on low visibility, precisely a restricted Runway Visual Range (RVR). Little RVR becomes a limitation to flight operations, when runway and aircraft equipment are not able to comply with rules and regulations to land under such conditions. In this case, flights must be cancelled with numerous passengers affected. This report will detail the extent of low RVR at Guernsey, implications for Aurigny and mitigation strategies.

2.0 Hours with Low RVR 2017

Table 4: Low RVR Hours 2017

MONTH	HOURS <600 RVR	HOURS <300 RVR 05:20-21:20 (LOCAL)	300<600 RVR
JANUARY	14.5	0	14.5
FEBRUARY	37.5	20.65	16.85
MARCH	59.5	34.15	25.35
APRIL	7.9	6.8	1.1

MAY	13	7.3	5.7
JUNE	7	3.6	3.4
JULY	11.5	5.3	6.2
AUGUST	9.25	4.1	5.15
SEPTEMBER	1.7	1.5	0.2
OCTOBER	9	3.3	5.7
NOVEMBER	0.5	0.25	0.25
DECEMBER	6	3.1	2.9
ANNUAL TOTALS	177.35	90.05	87.3

Table 1 outlines the monthly hours, where the RVR was below 600 metres or below 300 metres at Guernsey Airport. In 2017, 87.3 hours fall in-between an RVR of 300-600m. At this RVR Clearvision™ has the capability to enable landing of aircraft, which would have failed to land without this system.

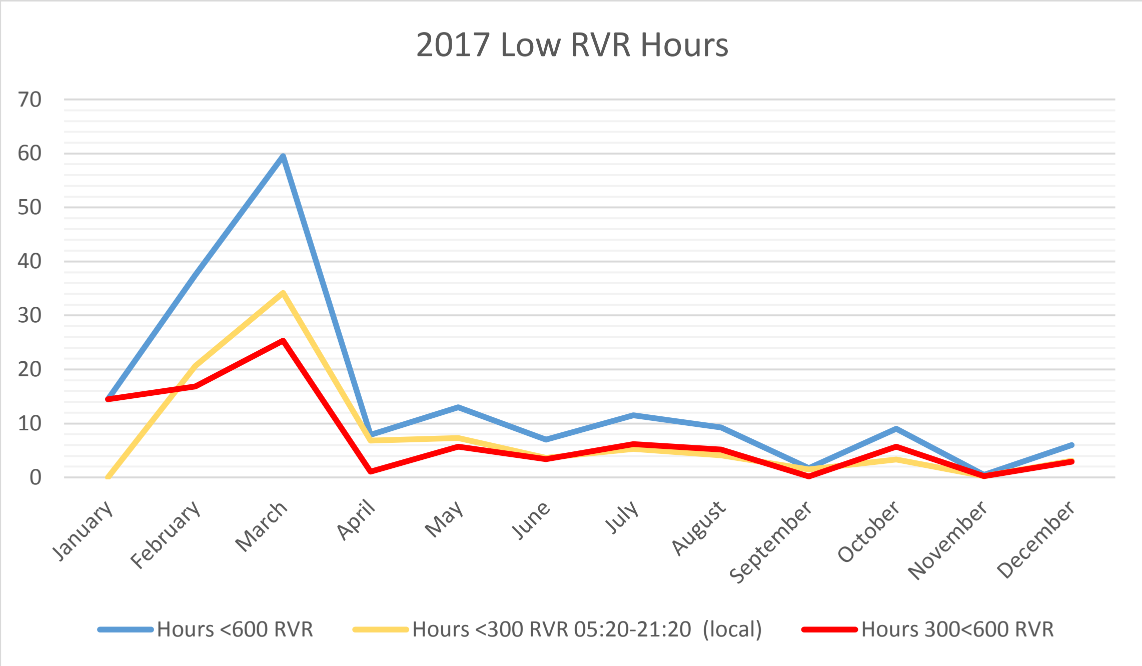

Figure 14: Diagram of Low RVR Hours

During 2017, Clearvision™ could have provided operations in 49% of the hours, where operations were cancelled due to poor vision. This is depicted graphically in Figure 1, where the red line represents hours that could be recovered using the Clearvision™ system.

2.1 Disruption Costs

Table 5: Disruption Expense

YEAR	2016	2017
DELAY COST (£)	129,503.26	127,933.72

Table 2 details the total expenses to be paid by Aurigny. The delay cost is comprised of hotel accommodation for passenger, journey costs of re-routing and additional airport handling charges resulting in delayed flying and prolonged grounding due to weather.

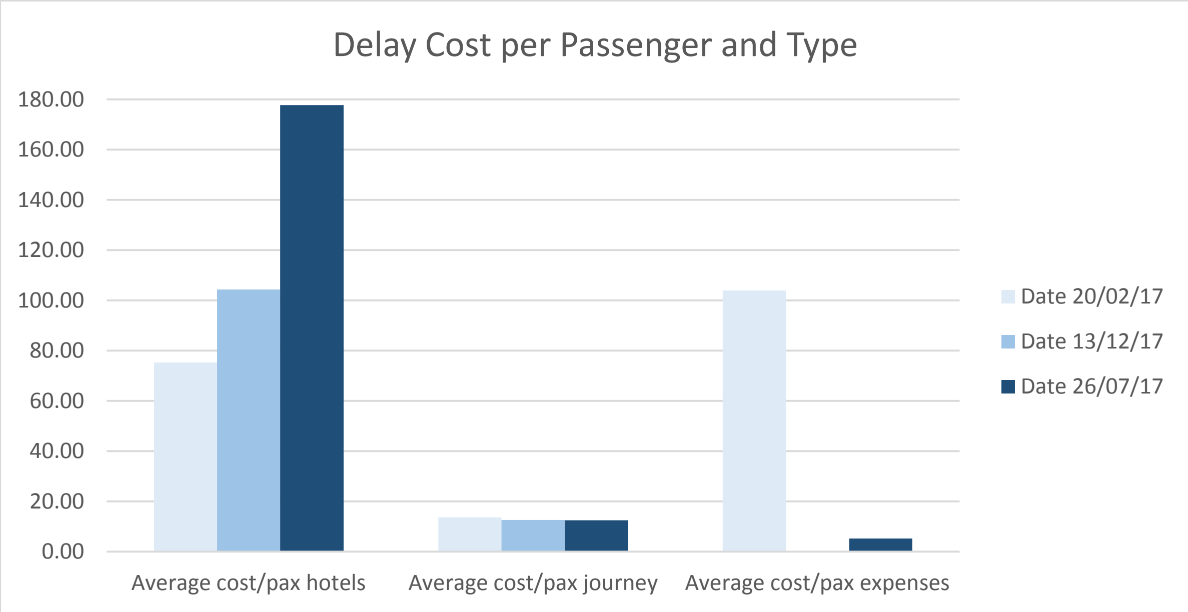

Figure 15: Diagram of Delay Cost

Figure 1 displays the delay costs on 3 selected days of disruption in 2017. It is shown that the average cost per passenger spent on hotel costs varies significantly between the 3 days. The costs variable factor lies in the specific circumstances of the delay including the location and size of the airport, events in the respective city at that time and the time of day the passengers are required to check in and out of the hotel. Hence, accommodation expenses prove to be difficult to foresee in magnitude.

Journey costs on the other hand, remain similar throughout the 3 different scenarios. The costs of hiring taxis, buses or vans within the UK remains largely similar with distances between airports and airport hotels also roughly identical.

2.2 Disruption due Technical Failure

In 2017, 41 scheduled passenger services were cancelled, 16 delayed by over 3 hours due to a technical fault on the ATR aircraft. This affected approximately 2,736 passengers, of whom 1,368 were eligible to claim for compensation. Technical failures increase in frequency with the ageing of the aircraft. The 1,368 passengers that were entitled to EU-261 compensation (equivalent to £220 p.p.) represented a liability of £300k for Aurigny. At present, 30% of eligible passengers claim for EU-261 compensation, but the number of passengers demanding compensation following a delay or cancellation is expected to significantly increase in the coming years. In addition to the compensation, Aurigny would have been liable for the costs of providing accommodation, meals and ground transportation.

Factory-new aircraft such as the ATR 72-600 will significantly decrease the number of "in-service" technical failures. Hence, an enhanced reliability of service and significantly reduced disruption/compensation costs for both the passengers and Aurigny.

3.0 Conclusion

Due to its geographical location, Aurigny fights a high number of weather-related events each year disrupting the planned operating schedule. This occurs in addition to any technical failures or human-induced disruption. Resulting are numerous delays and cancellations, in which Aurigny is partially liable to legal compensation in the form of EU-261 and the provision of further transport of those passengers. In total, this represented a cost of £127,933 towards the airline.

Enhanced vision in form of the Clearvision™ system aboard ATR 72-600 aircraft could eradicate up to 50% of the disruption caused by low RVR in Guernsey. Hence, a significant reduction of cost. All flying hours in the range between 300m and 600m RVR could potentially be recovered using this system, flying passengers to their destinations and avoiding disruption. Furthermore, new aircraft have the capability to lower disruption cause by technical issues and failures, which are far less likely to occur than on ageing airframes.

Appendix 8 - Analysis of Operating Lease vs Purchase

[redacted]

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Appendix 9 - ATR 72-500 Market assessment and Ascend Market values

The current ATR market is widely described as 'difficult'. Over 50 of ATR's used aircraft are stored around the world awaiting a new owner or lease agreement. Notably, this number is far greater than it has been 5-7 years ago. 25 to 27 of these aircraft are ATR 72-500, with similar specifications to G-COBO and G-VZON of Aurigny.

Market conditions have been considered "soft" and difficult over a time of 3 years. This is due to many sellers trying to place aircraft with few potential buyers, creating competition, hence driving down the sales price of such aircraft. Sales prices of used ATR 72-500, in a similar age bracket and conditions to Aurigny's may range from USD7-8 million. However, this is not confirmed by any recent transaction concerning such aircraft, as the last sale of a comparable airplane dates 1-2 years back. Leasing opportunities are considered far greater than sales opportunities for ATR 72-500 aircraft delivered 2005 or later. Sales activity is largely comprised of very early built aircraft in less pristine conditions, at comparatively low prices. Any prospects for a sale would be spontaneous or "under the radar", in any case hardly foreseeable for the seller. Should a potential buyer identify themselves, competition between buyers will deflate the sales price. Airlines and leasing specialists voice a preference for the ATR 72-600 for use in passenger configured services, leaving ATR 72-500s at a disadvantage.

Specifically, recently built ATR 72-500, on-condition and EASA airworthy (e.g. G-COBO) "will be difficult to sell" under current conditions. An emerging market arises within the freight industry, converting used ATR 72 freighter aircraft for use of feeder flights. Demand for these regional cargo services exists around the world, especially within the African subcontinent. However, for a 2009 built aircraft to be of suitable age and condition for this market, one would have to wait between 3-5 years. Freight operators prefer older aircraft due to the nature of their operations. There is a tendency for the market to potentially stabilise in the coming 3 years, as the emerging cargo conversions trend proceeds. Underlining this trend, the market for ATR 72 built in the early 2000s is already showing improvement.

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Figure 16: ASCEND Values G-COBO

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Figure 17: ASCEND Values G-VZO

Appendix 10 - Operating lease vs Ownership comparison

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APPENDIX 3

PA NYRAS

AURIGNY – ACQUISITION OF ATR - BUSINESS CASE REVIEW

NOTE: Redaction has been used to protect confidential terms or parties to the transaction

Nyras

now part of PA Consulting Group

PA

Aurigny - Acquisition of ATR - Fleet Review

Phase 2: Business Case Review

Prepared for: Alastair Ford, Head of Shareholder Executive - STSB

Date: 19/10/2018

Phase 2 requirement

PA Nyras has previously carried out a Phase 1 review of the Fleet Review that supported the Business Case to replace the existing ATRs with three new ATR 72-600s financed with 100% debt guaranteed by the State.

The Phase 2 work consists of the following which is the subject of this report:

"The specific advice and guidance on the robustness and completeness of the following aspects of the business case:

- The underlying **assumptions** that have been adopted for the purposes of the business case;
- The optimum **timing** of the purchase of the aircraft;
- The **change management** factors that have been identified as requiring planning in transitioning from the series 500 to the series 600 aircraft;
- The **aircraft acquisition options** that have been considered; and,
- The **risks** that have been identified as requiring management.
- Also, comment on the extent (if any) of any **optimism bias** that may have unduly influenced the business case's recommendations"

The scope of our work was limited to that set out above. This report has been written so as to be incremental to the reading of at least the executive summary to the Aurigny business case; it is not a summary of the business case.

The proposed transactions and actions

The business case relates to the following:

1. Purchase of three new ATR 72-600s from ATR
2. The sale of the two owned ATR 72-500s to ATR (as part of the above purchase) that includes a minimum sale price. ATR would be appointed as remarketing agent for the two owned ATRs with no fee payable. Aurigny can appoint a further remarketing agent at its own cost
3. The return of the leased ATR 72-500 and prior to that its sublease for up two years to an airline once the replacement aircraft has arrived
4. The disposal of the aging ATR 42-500
5. A loan from [redacted] to cover the full purchase price of the new ATRs. Early drawings are permitted to cover the Pre-Delivery Payments
6. A guarantee to [redacted] for the loan by the States of Guernsey
7. The refinancing of the existing ATR loan from RBSI

8. The transition of the fleet, pilots and maintenance capability
9. Implementation of ClearVision
10. Delivery of the benefits set out in the business case

Process followed by PA Nyras for the business case review

1. PA Nyras initially carried out a **Phase One review on the fleet review** commissioned by the Aurigny Board. For this review we issued our draft report in July 2018. In that report we indicated our expectations of content for the business case based on a draft business case of May 2018.
2. The **Phase Two work consisted of** review of the business case Word document along with the associated financial spreadsheet model.
3. We specifically **focused on the six areas requested** as part of the review but we also focused on supporting the development of a comprehensive business case. PA Nyras writes fleet renewal business cases for airlines so is familiar with the expected content.
4. We carried out a detailed **review of the financial spreadsheet** model for reasonableness. What we did not do is check the logics in the spreadsheet nor did we check back the figures in the spreadsheet to source documents. Our focus was on the assumptions and how they were used in the model.
5. We have had a significant number of **conversations with the STSB** about the business case to enable it to achieve the required analysis of options. We have had **email exchanges and calls with Aurigny** in relation to detail in and for the business case.
6. So this report only picks up on key points from an **extensive process** of involvement.
7. PA Nyras has sought to **influence inclusion of items considered significant** rather than report by exception on items not presented. Aurigny has been responsive to these discussions so the exceptions in this report are brief.

Executive summary

The key factors to consider in relation to the business case are:

1. PA Nyras **supports the business case overall recommendation** of ATR fleet replacement with new aircraft from ATR and 100% financed by [redacted], on the terms in the two proposals.
2. We note the importance of **timing of signature of the various binding offers** then contracts to avoid Aurigny having unfinanced commitments.
3. The **LoI from ATR expires** on 31 October so an extension will need to be sought.
4. We consider that Aurigny has carried out a **thorough exercise** in preparing the business case
5. On the basis of the ATR & [redacted] terms, **key to the business case** are the following:
   1. The number of maintenance days for the ATR/E195 fleet
   2. The rising maintenance costs for the existing ATRs
   3. Flight delays and their costs
   4. The benefits of ClearVision in reducing delays
   5. The sublease income from placing the leased ATR 72-500 with another airline for up to two years
   6. Whilst the existing ATRs are only nine years old, the financial business case clearly shows the benefit of replacement

Executive summary (2)

Continued: the key factors to consider in relation to the business case are:

1. This report has been conducted independent of potential **macro events** in the business environment such as Open Skies, a runway extension and Brexit. Our view is that these will play out as they will regardless, as would any mitigation strategies implemented by Aurigny. Still, we believe that the impact of such events should not be materially different whether one orders new aircraft or continues to operate with the existing fleet.
   1. It is the view of PA Nyras that ownership of **new aircraft vs leasing** allows greater flexibility to address changes in the market environment that might develop in the future; and in a downturn newer aircraft are typically more saleable than older aircraft and aircraft types out of production.
   2. One macro risk to be considered is the potential **foreign exchange risk** between the USD (US dollar) and GBP (Pounds £) between the date the Aurigny commit with ATR to the purchase of the aircraft and the delivery dates of the aircraft (plus Pre-Delivery Payment dates prior to then). Aurigny could consider hedging this exposure.
2. The timing of this offer from ATR is such that they need the order for two reasons. Firstly, Market intelligence would suggest that ATR had oversold to lessors who have yet to place those aircraft with airlines. Manufacturers need to be in a position to have a steady order stream. We believe ATR therefore needed this order and to beat the pricing available from lessors as rentals. Secondly, they also appear to need to put into operation ClearVision at the earliest opportunity with an accessible and reputable operator with high fog occurrence to enable them to effectively market the capability to other airlines. The pricing for the new aircraft appears to be a good offer and the sale price to ATR for the two -500s is above market; where there are c.25 used aircraft currently being marketed. The two sets of prices combined make this a good offer that we believe might not be replicated again in the future.

Executive summary: business case outcome

1. The financial case shows a positive outcome on a ten year basis from both a P&L and cash flow perspective. The gain between retaining the -500s and buying new -600s is £4m. PA Nyras considers this to be a reasonable estimate of the outcome, based on the information provided.
2. There is a large forecast P&L loss in 2019 which needs investigation from an accounting perspective to see if some of it shouldn't be taken in 2018 and some spread into future years. A loss in 2019 may not convey the most appropriate message about the benefit of this business case. So all efforts should be made to review accounting standards to see what is possible and also consider changes to contract terms.

	£000s
Maintenance Cost saving	15,976
ATR Credit memos for Services	333
Additional Depreciation & Interest cost, less lease cost savings	(10,853)
Additional Insurance cost	(343)
	5,112
Reduction in Delay & Disruption and EU261 costs - reliability	1,695
Reduction in Delay & Disruption and EU261 costs - Clearvision	1,100
	7,907
Transition Costs	(575)
Book loss on sale of owned ATR72-500s (G-COBO & G-VZON)	(456)
Interest on pre-delivery deposit payments	(245)
Loan arrangement fee	(343)
Improvement in Profit & Loss versus Baseline	6,289
States of Guernsey Guarantee fee	(2,206)
Improvement after SoG Guarantee	4,082

Aurigny might also wish to consider reviewing its aircraft deprecation policy going forward, given the loss arising from the sale of the -500 aircraft at what is a guaranteed value that is on the high side

Issues brought forward from the Phase One fleet review

Various issues from Aurigny's Fleet Review and draft business case were brought forward in our Phase One Report to this Phase Two work:

1. There had been no analysis performed of historical use of standby aircraft / capacity: in the business case, the analysis has since now been satisfactorily performed
2. The pros and cons of a third new -600 had not been compared in the Fleet Review to retaining long term the leased -500: whilst no explicit evaluation has been carried out in the business case, we have seen enough information to be comfortable that a third new aircraft is the optimal approach; this point is covered later in our report
3. Relative maintenance costs between new -600s and used -500s had not been made in the Fleet Review and could not be seen from the draft business case we received for our Phase One work: we have since reviewed the financial model and we consider these estimates to be reasonable
4. Further information was provided by phone with Aurigny during Phase One: this information has now been included in the business case with the exception of analysis of Open Skies risk
5. The financing arrangements were not evident to us during Phase One: we have now reviewed those arrangements and they are discussed in this report

6. When the signed offer from ATR was reviewed, it was not clear whether the two -500s to be sold to ATR met the return conditions in Exhibit D nor was it clear the net proceeds to be received form ATR for the sale of the two aircraft. This information has since been documented in the business case and is discussed later in this report

Contents

Six review areas

Underlying assumptions

Other than the transactions themselves, the key assumptions underlying the business case are as follows:

1. The number of maintenance days for the ATR/E195 fleet
2. The rising maintenance costs for the existing ATRs
3. Maintenance costs for the new ATRs in a maritime environment
4. Relative engine overhaul costs between -500s and -600s
5. Flight delays and their costs
6. The benefits of ClearVision in reducing low visibility delays
7. The sublease income from placing the leased ATR 72-500 with another airline for up to two years

We consider that these assumptions are reasonable and the way they have been applied in the financial model. Aurigny appear to have included the relevant costs in the financial model (however, we have not received nor carried out a review of Aurigny's financial statements to know if this is definitely the case).

Optimal timing

There are three choices for timing of fleet replacement:

1. Replace two now and third when the lease expires in 2021 on the third aircraft
2. Replace all three now
3. Wait to the end of the aircrafts' economic lives in operation with Aurigny, mindful of maritime conditions

Aurigny has evaluated these choices.

1. The main financial model compares Option 3 as the base case with Option 2. Option 2 wins.
2. Aurigny have made a comparison in the business case of deferring the third new aircraft until the leased -500 is returned (Option 1 v 2). This shows that it is beneficial to take all three new aircraft now.

3. A fourth option could be to order the new aircraft some years later for delivery shortly before the two owned ATRs have their next engine overhauls in c.2024.
    1. There is no guarantee that the good terms on offer now from ATR would be available at that time.
    2. Ordering now for delivery in c.2024 is not an option since manufacturers' escalation would significantly erode the benefit of the new aircraft. (Manufacturer escalation applies an inflation increase each year to the price which tends to be higher than the prevailing national inflation rates.)
    3. Also the price adjustment mechanism in Exhibit D of the Offer would adjust for the extra life burnt on the engines largely eradicating the benefit of using that life. (Exhibit D sets a headline price for the sale of the two -500s then adjusts for the maintenance state of the aircraft at the time of the sale. So an extra 4-5 years' life used on the engines comes straight of the sales price.)

    So we would not recommend consideration of this as an option.

Change management factors for transition

1. The transition is relatively straight forward compared to a change to a new aircraft type
2. The airline has an outline plan developed.
3. The Engineering team have by far the most to achieve. An onsite presence with ATR plus aircraft specification are key. Also they will be managing the returns of the three aircraft where significant unexpected costs can arise if there is not a clear plan and physical oversight.
4. It is also a good opportunity to consider whether optimal contracts exist to support the aircraft and also spares holdings
5. ATR has yet to gain ClearVision approvals and whilst not critical to the business case, it is understood to deliver real benefits to Aurigny and its passengers. A notable competitive advantage should arise and be translated into revenue improvements (not in the business case)
6. Delivering the benefits in a business case are often a lower priority in change management as focus on the functional transition evolves. Actions plans with regular monitoring need to be developed to ensure benefits realisation

Aircraft acquisition options

The choices available to Aurigny were:

1. Operating lease
2. Asset backed commercial financing
3. Export Credit financing
4. State guaranteed unsecure loan

Due to the State's high credit rating, banking regulations, the profitability of the airline and asset risk relating to the aircraft, the optimal financing is unsurprisingly a State guaranteed unsecured loan.

Aurigny has followed a full process to evaluate these sources, except for export credit financing but it is highly unlikely this would be preferable to the State guarantee due to the OECD regulated terms.

Risks

The following risks should be considered:

1. ClearVision, which would be free of charge for Aurigny, not being approved by EASA or not being approved for operation at Aurigny
2. ClearVision not delivering the enhanced visibility to make a difference on fog affected days
3. Macro risks and their implications for fleet investment:
    1. Brexit: what implications are there for Aurigny from any studies carried out by the State?
    2. Open skies: it is too early to know whether this will prove beneficial, of negligible benefit or detrimental to Aurigny and or the State
    3. Runway extension and improved navigation equipment could invite increased competition and challenging Aurigny's commercial position. Any impact at a macro level should be further considered
4. The new aircraft are priced in USD and the loan is in GBP. We assume [redacted] would amend the loan amount for any difference, given GBP current volatility due to Brexit
5. Aircraft residual value risk: Aurigny has found a means of successfully disposing of its existing mid-life ATRs. Aurigny might not be so fortunate at a point when it wishes to dispose of these new aircraft. One of the benefits of leasing is putting this risk with the lessor. The downside of leasing is the potentially higher ownership and maintenance costs. There is also currency risk for the residual value since aircraft are valued in USD
6. 50% bullet repayment at Year 10 of loan compared to residual value above: there is a risk that the residual value of the aircraft will be less than the bullet repayment amount. This has been the case with the proposed disposal of the -500s; presumably the State will continue to guarantee the refinance of the remaining loan balance. We have not reviewed the finances of the airline to consider such a path, we merely highlight the risks.

Optimism bias

The business case is factual albeit with a significant number of assumptions needing to be made about the future. Those assumptions are reasonable.

There are two areas where there is clearly some aspiration involved (but not bias):

1. Fog related delays: Guernsey Airport is notorious amongst residents and regular visitors to the island for fog related delays. The airport currently has its limitations in terms of air navigation equipment. At some point in the future investment may be made at the airport. The aircraft types using the airport have some greater capability if the airport installs such systems. Meanwhile, Aurigny has been attracted to the ClearVision system that is being certified through EASA for use on ATR 72-600s. As we understand it, the system would enable the pilot's decision height for whether to land or not to be reduced from 600 feet to 300 feet. This is likely to mitigate some of the fog delays but by no means all of them. It is not financially critical to the business case.
2. Maritime climate related maintenance costs: aircraft don't like salt water spray. Despite how well built they are, they still incur higher maintenance costs than in other conditions. Aurigny hopes that by having new aircraft it will improve the predictability of maintenance costs. By the time the aircraft require major airframe checks and full engine overhauls they will be at a similar age as previous aircraft had the same cost estimation issues. A provision has been made in the business case for such extra costs.

We also note the intended sublease of the leased ATR 72-500 for up to two years. There are a significant number of such aircraft being remarketed at present. Historical experience suggests that luck as much as judgement comes into whether such income arises. ATR is due to provide a rental subsidy to support sublease but ATR has its own -500s to place on sale or lease

Conclusion

Conclusions and recommendations

1. PA Nyras supports the proposed fleet replacement and on the terms negotiated
2. As stated previously, we consider the Offer currently available from ATR as a good deal for Aurigny
3. We believe that Aurigny has gone through an adequate process to come to this conclusion

4. Whilst the fleet replacement does deliver an average annual profit improvement of £0.4m (£0.6m excluding the cost of the States loan guarantee), it doesn’t deliver the big breakeven gains needed to put Aurigny on a path where it can grow and have a greater impact as an economic enabler. We strongly recommend that Aurigny goes through a profit improvement programme to then enable the traffic decline to be reversed and either stay static or ideally start growing again for the benefit of the people of Guernsey

Contact

We thank you for appointing PA Nyras to support the States of Guernsey with this important assessment

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APPENDIX 4

POLICY & RESOURCES COMMITTEE

AURIGNY – REPLACEMENT OF ATR72 FLEET – LETTER OF COMMENT

Policy & Resources
Committee

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The President
States' Trading Supervisory Board
Brickfield House
St Andrew
GY6 8TY

08 November 2018

Dear Deputy Ferbrache

Aurigny – Replacement of ATR72 Fleet

Thank you for your letter dated 24 October 2018 enclosing a draft Policy Letter; propositions; and accompanying appendices concerning the proposed replacement of Aurigny's ATR72 fleet of aircraft.

It is noted that, until such time as a contract is entered into, there is exchange and interest rate risk but the Committee notes that the replacement aircraft are projected to have a positive cumulative financial effect of over £4million for the company. In addition, there are wider benefits, particularly the potential for the ClearVision system to reduce weather related disruption for passengers.

Therefore, the Policy & Resources Committee is pleased to advise that it unanimously fully supports the proposal to replace the existing three ATR72-500 aircraft with ATR72-600 aircraft and, subject to States' approval, will facilitate the purchase by either making a loan available from the proceeds of the States of Guernsey bond issue or by guaranteeing borrowing from a third party.

The Committee would like to take this opportunity to reiterate the importance of measuring the benefits realised and judging the success of these acquisitions by assessing the extent to which the investment objectives and desired outcomes are realised.

Yours sincerely

Gavin St Pier
President, Policy & Resources Committee

States' Trading
Supervisory Board

THE STATES OF DELIBERATION
of the
ISLAND OF GUERNSEY

STATES' TRADING SUPERVISORY BOARD

AURIGNY AIR SERVICES – AIRCRAFT ACQUISITIONS

The President
Policy & Resources Committee
Sir Charles Frossard House
La Charroterie
St Peter Port

9th November, 2018

Dear Sir,

Preferred date for consideration by the States of Deliberation

In accordance with Rule 4(2) of the Rules of Procedure of the States of Deliberation and their Committees, the States' Trading Supervisory Board requests that the Propositions be considered at the States' meeting to be held on 12th December, 2018.

The Propositions relate to the proposed acquisition of new aircraft by Aurigny Air Services (Aurigny) from the manufacturer, ATR. Aurigny has signed a Letter of Intent with ATR that has enabled it to secure the terms of the acquisitions with the manufacturer so that it could then present its business case with certainty to the States' Trading Supervisory Board. This Letter of Intent was initially due to expire on 31st October, 2018. However, Aurigny has advised that it has now agreed an extension to its terms with ATR until 20th December, 2018, to enable the States to consider the Propositions.

Yours faithfully,

P T R Ferbrache
President

J C SF Smithies
Vice President

J Kuttelwascher, Member
S J Falla, MBE, Non-States Member
J C Hollis, Non-States Member