



XVII  
2013

# BILLET D'ÉTAT

TUESDAY 30th JULY 2013

TREASURY AND RESOURCES DEPARTMENT  
AURIGNY AIR SERVICES - AIRCRAFT  
ACQUISITIONS

# **BILLET D'ÉTAT**

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**TO  
THE MEMBERS OF THE STATES  
OF THE ISLAND OF GUERNSEY**

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I hereby give notice pursuant to Rule (1)(4) of the Rules of Procedure of the States of Deliberation that the item contained in this Billet d'État which has been submitted for debate will be considered at the Meeting of the States of Deliberation already convened for **TUESDAY, the 30<sup>th</sup> JULY, 2013.**

**R. J. COLLAS**  
Bailiff and Presiding Officer

The Royal Court House  
Guernsey  
9<sup>th</sup> July 2013

**TREASURY AND RESOURCES DEPARTMENT****AURIGNY AIR SERVICES – AIRCRAFT ACQUISITIONS**

The Chief Minister  
Policy Council  
Sir Charles Frossard House  
La Charroterie  
St Peter Port

2<sup>nd</sup> July 2013

Dear Sir

**1. Executive Summary**

- 1.1 Following the recent announcement by Flybe that it is withdrawing its services between London Gatwick and Guernsey next March, Aurigny Air Services has been evaluating options for the expansion of its existing operations on the route to cater for the passenger numbers previously carried by Flybe.
- 1.2 Given the strategic importance of air services on this route, it is important that the market place is reassured at as early an opportunity as possible that Aurigny intends to safeguard the link by providing sufficient capacity to cater for the passenger numbers previously carried by Flybe.
- 1.3 Subject to the completion of the necessary options appraisal and approval of a business case, this Report recommends that if the Aurigny Group wishes to borrow funds to purchase such additional aircraft that may be required to safeguard the service, the Treasury and Resources Department be authorised to provide such guarantees as may be necessary to facilitate such borrowing. In the event that it is concluded that leasing additional aircraft would be more appropriate, then the report also recommends that the Department should be authorised to act as a guarantor to such leases. This will enable the airline to finalise the development and implementation of plans for the expansion of its service within the relatively tight timescales that are available.

**2. Background**

- 2.1 In 2003, the States of Guernsey agreed<sup>1</sup> to purchase the Aurigny Group so that it could ensure the continuing operation of the former British Airways services between Guernsey and Gatwick by Aurigny Air Services.

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<sup>1</sup> Resolution 1 of Billet d'État XI of 2003

- 2.2 The purchase of the Aurigny Group reflected the strategic importance of air transport to the Island and, specifically, hub access to London Gatwick Airport. Air transport is essential for the Island's population in terms of family contacts, as well as social services such as medical facilities and treatments and access to education and training in the UK. Such links are also fundamental to the long-term economic sustainability of the Island. Finance and business services represent over 50% of the Island's GDP and good air links to one of the two principal London hub airports are a major factor in the long-term success of the sector. Tourism on the Island is also heavily dependent on air links to London and, in turn, the success of tourism is necessary for the survival of the air links on which business depends.
- 2.3 Since its purchase by the States in 2003, Aurigny Air Services has operated the service between Guernsey and Gatwick in competition with Flybe. It initially began operations on the service with 3 daily pairs of landing slots, but since then, has increased its slot portfolio to 6 daily pairs of slots. In 2012, the airline was the dominant operator on the route, carrying 198,918 passengers on the service, compared to 146,207 carried by Flybe. Appendix 1 sets out Aurigny and Flybe passenger and capacity numbers since Aurigny commenced operations on the route in 2003.
- 2.4 On 23<sup>rd</sup> May of this year, Flybe announced that it was withdrawing all of its existing services from Gatwick Airport and that it had reached a conditional agreement to sell its slot portfolio to Easyjet. The airline cited the pricing regime applied by the owners of Gatwick Airport on the operators of smaller regional aircraft, together with what it regarded as the punitive levels of Air Passenger Duty imposed on domestic services, as the main reasons for its decision, noting that none of its services at Gatwick had returned a profit over the last year.
- 2.5 It is important to note that the slots sold by Flybe to Easyjet are not tied to the routes they had previously been used to operate. At this time, Easyjet has not confirmed the routes on which it intends to deploy its newly acquired slots.
- 2.6 Flybe is currently planning that its operations between Guernsey and Gatwick will cease to operate with effect from 29<sup>th</sup> March, 2014.

### **3. Aurigny – Proposed Response**

- 3.1 With the support of the Treasury and Resources Department and, in the short time that has been available since Flybe's announcement, Aurigny has been developing detailed options for an expansion of its existing operations on the service between Guernsey and Gatwick. The Department expects the airline to finalise these within a matter of weeks. These options centre around the introduction of larger jet aircraft on existing schedules or the operation of smaller turboprops at increased frequencies or a combination of both.

- 3.2 The turboprop option is contingent on the airline securing additional slots at Gatwick Airport. Initial discussions continue to indicate that these may be available for allocation from the existing slot pool without having to purchase them from other airline operators. However, it is unlikely that confirmation about the availability of slots will be received until November. Given the lead-in time for acquiring additional aircraft, this delay may preclude further consideration of this option.
- 3.3 The withdrawal of the existing Flybe service will result in capacity on the route being reduced by an average of between 688 seats per day (based on its 2012 operation) and 720 seats per day (based on its 2013 operation). This shortfall would be almost entirely eliminated by the option involving the acquisition by Aurigny of a jet aircraft with around twice the capacity of its existing ATR aircraft, plus the possibility of additional flights outside of the early and late daily take-off and landing slots.
- 3.4 In the meantime, both the Department and the airline recognise the importance to the Island of providing reassurance at an early opportunity that Aurigny will safeguard this strategically important service and of sending a clear message to the market of the Company's intent. Given the importance of the service to so many sectors of the Island and its economy, it is vital that confidence is maintained that an adequate service will continue to be provided following Flybe's withdrawal. The Department and the airline are committed to ensuring this is the case and the options that are being evaluated at this time demonstrate that the airline will be able to expand its operation and provide sufficient capacity to cater for the passenger numbers most recently carried on the service by Flybe. In short, it is Aurigny's intention to fill the gap for the passenger numbers left by Flybe.
- 3.5 What is also clear from the options appraisal is that Aurigny will need to acquire additional aircraft to support an expanded operation. A decision on the aircraft type, the number required and whether operating leases or outright purchases would be the most appropriate approach will only be made upon completion of the options appraisal and approval of the necessary business case by the Department. The lead-in times for the delivery of additional aircraft can be significant and, in the event that jet aircraft are introduced to the Aurigny fleet, there will be additional regulatory issues to be addressed. **Whilst the Company is confident that this process can be completed before next March, it must be recognised that the timescales are tight and that, after settling on the preferred option, the airline will need to be in a position to move quickly to acquire the necessary aircraft.**

#### **4. Funding Arrangements**

- 4.1 Following consideration of a report from the Department in 2005, it was concluded that the most appropriate approach for meeting the Aurigny Group's funding requirements was for it to seek third party funding. Accordingly, the

States resolved<sup>2</sup> to authorise the Treasury and Resources Department to facilitate (if necessary by providing guarantees) the Aurigny Group's borrowing from third parties. Whilst the funding requirements identified at that time did identify some requirements for capital investment, it was not the intent that this resolution should extend to loans that might be required in the future for additional aircraft.

- 4.2 In 2007, following a proposal from Aurigny Air Services, it was agreed that the Company should purchase two new aircraft for operation on its route to London Gatwick and other regional UK services. These were to be funded by third party loans made to the Company. Accordingly, the States further resolved<sup>3</sup> to authorise the Department to facilitate, if necessary by providing guarantees, the Company's borrowing to finance the purchases.
- 4.3 In the event that a decision is now made to purchase rather than lease, the Department continues to believe that the most appropriate mechanism for funding the purchase of any additional aircraft is through borrowing. Such borrowing avoids the need to draw down on the States' own capital reserves.
- 4.4 The Department continues to believe that the retention of the Aurigny Group in the ownership of the States remains overwhelmingly in the public interest. Its accumulated losses at the end of 2012 were £12.5million. Subject to the outcome of the States' debate on the capital prioritisation process in September, the Department will be submitting a further report towards the end of this year to the States on the long-term financial, strategic and operating arrangements for the airline, the objectives that are set for it and the recapitalisation of the Aurigny Group.
- 4.5 However, if the airline is to be in a position to provide a positive and timely response to Flybe's withdrawal and establish sufficient additional capacity on the route, then it will need to make a decision on the acquisition of additional aircraft before the aforementioned Report is submitted. It can only do so if it knows that the appropriate guarantees from the Department for borrowing from third parties can be put in place or, alternatively, that it could borrow the necessary funds from the States General Investment Pool. The Department is satisfied that this will not prejudice the terms of its proposed report to the States later this year.
- 4.6 It is not possible at this time to state with certainty what the likely acquisition costs will be. These will only be determined as the options appraisal, business case and negotiations with suppliers are finalised in the coming weeks. **For purely indicative purposes only**, Appendix 2 includes a table setting out typical costs of acquiring aircraft within the capacity range required by Aurigny. It is important to recognise that there are many variables that can affect the purchase costs and lease charges set out in this table, including:

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<sup>2</sup> Resolution 2 of Article XII of Billet d'État IX of 2005.

<sup>3</sup> Resolution 1 and 2 of Article X of Billet d'État XVI of 2007

- The type and age of the aircraft;
- The length of the lease (monthly rates for shorter-term leases are invariably more expensive than longer-term rates);
- The material discounts that are usually negotiated over the list price for new aircraft;
- Aircraft availability.

The Company anticipates that only one additional aircraft, either a jet or a turboprop, would need to be acquired.

4.7 For the avoidance of doubt, the States would not be providing the funds to the Aurigny Group, but rather would be facilitating, if necessary through guarantees, the Group borrowing the necessary funds from third parties. Alternatively, it could borrow from the States General Investment Pool. Whilst an aircraft purchase with an accompanying loan guarantee from the States could potentially entail risk if the Group ceased trading, there would be a capital asset which could be used to repay the loan. The potential risk is that the residual value of the aircraft at that time would be less than the value of the outstanding loan.

4.8 Aurigny is currently estimating that the “bottom line” performance of the airline over its existing operations would be improved by between £1.7million and £3million per annum, depending on which aircraft acquisition option is exercised. For the purpose of this exercise, these estimates assume no change in current fare levels, but importantly, also assume that it remains the sole operator on the Gatwick route. The Department feels that there would be merit in considering the pros and cons of amending the States’ existing air transport licensing policy statement to provide for a sole operator on the route, possibly linked to minimum service standards and fare controls. It intends to address this as part of its aforementioned wider report on Aurigny later this year.

## **5. Conclusions**

5.1 The Department believes that one of the principal objectives for Aurigny should continue to be the provision of an adequate service between Guernsey and Gatwick. Safeguarding this service was the main reason for purchasing the airline. Given the ever volatile nature of the airline industry and Flybe’s decision to withdraw from Gatwick, this reasoning is stronger today than it ever was. Relative to several other regions of the UK that are now facing the partial or full loss of their connectivity to Gatwick, the Island is in a unique and fortunate position to be able to respond to the situation.

5.2 Against the above background, the Department is seeking the authority of the States that, subject to appropriate due diligence, it can act as guarantor of such borrowing that the Aurigny Group may require from third parties for funding the purchase of any additional aircraft required to service the Aurigny network as a result of Flybe’s decision to withdraw from the Gatwick service. Alternatively,

the Department could be authorised to offer Aurigny a loan from the States General Investment Pool.

- 5.3 The Department stresses that any decision to exercise this authority would only be made after its consideration and approval of the necessary business case and in the event that it was satisfied that purchasing was the most cost effective and feasible solution to such an acquisition. Given the strategic importance to the Island of the Gatwick service, the Department intends to consult with the Policy Council before making its final decision on Aurigny's business case.
- 5.4 In the event that leasing is identified as being a better solution, then the Department is also seeking the authority of the States to join as a guarantor to any such lease if required.

## **6. Recommendations**

- 6.1 The Treasury and Resources Department therefore requests the States, as a consequence of Flybe's decision to withdraw from providing a service between Guernsey and London Gatwick:
- a) to authorise the Treasury and Resources Department to facilitate any borrowing by the Aurigny Group to finance the purchase of such additional aircraft as are required to service the Aurigny network by providing guarantees for borrowing from third parties or by offering the Group a loan from the States General Investment Pool; and
  - b) to authorise the Treasury and Resources Department to facilitate the leasing of any aircraft, including if required, acting as guarantor to the lease.

Yours faithfully

G A St Pier  
Minister

J Kuttelwascher  
Deputy Minister

A Spruce      H Adam      R Perrot

**APPENDIX 1****GATWICK – PASSENGER AND CAPACITY FIGURES**

<b>LONDON GATWICK - GUERNSEY</b>						
	<b>Passengers</b>			<b>Capacity</b>		
	<b>Aurigny</b>	<b>Flybe<sup>4</sup></b>	<b>Total<sup>5</sup></b>	<b>Aurigny</b>	<b>Flybe<sup>6</sup></b>	<b>Total</b>
<b>2003</b>	85,572	221,117	306,689	150,694	309,232	459,926
<b>2004</b>	115,764	223,162	338,926	177,888	310,704	488,592
<b>2005</b>	125,857	224,348	350,205	185,560	342,906	528,466
<b>2006</b>	137,031	215,649	352,680	185,670	328,994	514,664
<b>2007</b>	141,137	203,238	344,375	190,146	320,112	510,258
<b>2008</b>	139,261	199,868	339,129	189,062	307,397	496,459
<b>2009</b>	155,577	185,786	341,363	226,898	286,536	513,434
<b>2010</b>	160,248	174,876	335,124	229,234	276,694	505,928
<b>2011</b>	199,446	156,577	356,023	272,520	271,378	543,898
<b>2012</b>	198,918	146,207	345,125	262,563	247,937	510,500

<sup>4</sup> Figure calculated by subtracting Aurigny's passenger figures from total passenger figure for the route published by Guernsey Airport.

<sup>5</sup> Source: Guernsey Airport

<sup>6</sup> Source: Flybe Website

**APPENDIX 2****INDICATIVE AIRCRAFT ACQUISITION COSTS**

<b>AIRCRAFT ACQUISITIONS</b>				
	<b>Used Turboprop</b>	<b>New Turboprop (list price)</b>	<b>Used Jet</b>	<b>New Jet (list price)</b>
<b>Purchase Price:</b>	\$14 to \$16million	\$25 to \$26million	\$25 to \$26million	\$40 to \$48million
<b>Lease:</b>				
Monthly Charge:	\$140,000	\$200,000	\$220,000	\$300,000
plus				
Hourly Charge:	\$350	\$300	\$600	\$500

**Notes:**

1. The purchase prices set out above for new aircraft are based on the “list” price for the aircraft. Airlines will normally negotiate a substantial discount on the list price.
2. The hourly charges under lease arrangements are paid into a maintenance reserve account which is held as security in the event that an airline fails and goes into administration.
3. Prices quoted for a turboprop are based on an aircraft seating circa 64 passengers. Prices quoted for a jet are based on an aircraft seating circa 120 passengers.
4. Source: Aurigny Air Services

**(NB The Policy Council supports the Report.)**

The States are asked to decide:-

I.- Whether, after consideration of the Report dated 2<sup>nd</sup> July, 2013, of the Treasury and Resources Department, they are of the opinion:-

1. To authorise the Treasury and Resources Department to facilitate any borrowing by the Aurigny Group to finance the purchase of such additional aircraft as are required to service the Aurigny network by providing guarantees for borrowing from third parties or by offering the Group a loan from the States General Investment Pool.
2. To authorise the Treasury and Resources Department to facilitate the leasing of any aircraft, including if required, acting as guarantor to the lease.

