

**REPLY BY THE VICE-PRESIDENT OF
THE STATES' TRADING SUPERVISORY BOARD
TO QUESTIONS ASKED PURSUANT TO RULE 14 OF THE
RULES OF PROCEDURE BY DEPUTY LESTER QUERPEL**

As an elected representative of St Peter Port North, and consequently therefore, a representative of the taxpayers of the Bailiwick and guardian of 'the public purse', I am extremely concerned about the total lack of concern displayed by the States, to address the astronomical and completely unacceptable, annual losses of Aurigny. Being a member of the States Assembly, I am of the view that drastic and proactive action needs to be taken in an attempt to resolve these astronomical and completely unacceptable annual losses. Therefore the measures I feel the States should pursue are as follows:

1. The States takes control of Aurigny and puts their own management team in place.
2. All of the routes Aurigny currently operate are dispensed with, apart from the route to Gatwick, and possibly the route to Alderney, as long as an appropriate PSO can be agreed upon for the latter.
3. No further work to be undertaken to establish 'new' routes.
4. The planes Aurigny currently own are sold, or leased out, to other airline companies.
5. Planes needed to operate the route to Gatwick, and the Alderney route, if an appropriate PSO is put in place, are then leased.

Therefore, in relation to the above, I ask the following questions:

Question 1a

Can you tell me please whether or not the States Trading Supervisory Board would be in favour of such drastic and proactive measures?

Answer

As a precursor to my answer to this question, I should like to make three general observations:

- Firstly, some of the recent public commentary and criticism around Aurigny's results and projected losses has on occasion been subjective, ill-informed and inaccurate. Given its importance, the debate that we must have about the matter should be based on an objective assessment of the facts to ensure that we identify the right steps and measures to address those losses as effectively as possible, rather than knee-jerk reactions;
- Secondly, it is sometimes easy to forget when debating Aurigny that we are talking not just about its Board and its Directors, but about an airline that employs hundreds of people in the Bailiwick and further afield. Whilst our focus is understandably and

rightly on its financial performance, we should acknowledge the hard work those staff undertake with pride every day to provide the best service they can in what must sometimes feel like the unrelenting glare of public scrutiny. As owner of the airline, the States has a duty of care to those individuals - they are our people - to conduct the ongoing debate responsibly, maturely and objectively; and,

- Thirdly, we must acknowledge that Aurigny operates within a policy framework agreed by the States. In light of Aurigny's current position, the 2020 Budget Report¹ acknowledged that *"...there is an urgent need for a co-ordinated and coherent government approach to consideration of all aspects of air route operation and support to develop and safeguard air links to and from Guernsey that is under the control or influence of the States of Guernsey."* The Budget Report also noted that in the short-term, *"...there are limited options for temporary measures that could be introduced to mitigate these losses in any meaningful way. The possible long-term consequences of any permanent measures that would reduce these losses would need to be fully investigated and carefully considered."*

Therefore, responsibility for identifying steps to address the losses will require action not just by Aurigny and the States' Trading Supervisory Board (STSB), but by the States as a whole. The STSB therefore welcomes the States' recent decision to develop a government framework for the consideration of all aspects of air route operation and support, which will take account of the likely effects it has on Aurigny's financial position.

Within the context of the above, both the STSB and the Board of Aurigny absolutely agree that steps need to be taken to address the losses. However, determining which steps and measures would be the most effective must be based on a proper assessment of the facts to ensure that they are effective. They must also be assessed within the context of the aforementioned government framework that the States has committed to developing and the role that Aurigny is expected to play within it.

As such, the STSB does not agree that the measures set out in the question should be pursued at this time.

Question 1b

If the answer to the question is 'yes', then can you tell me when you will be pursuing such drastic and proactive measures please?

Answer

See response to question 1a.

Question 1c

¹ Article 1 of Billet d'Etat XXI of 2019: The States of Guernsey Annual Budget for 2020 (sections 8.35 to 8.42)

If the answer to the question is 'no', then can you tell me please why you don't see the need to pursue such drastic and proactive measures?

Answer

As I have set out in my response to Question 1a, the STSB agrees that action needs to be taken to address the losses, but those should be based on an analysis of the facts. So, let us start with what we do know.

Firstly, we have an independent report of an Efficiency and Benchmarking Review of Aurigny from specialist aviation consultants, PA Nyras. This was commissioned jointly by the STSB and the Scrutiny Management Committee (available to read at www.gov.gg/aurignyreview) and included amongst its conclusions that:

- Aurigny is generally well managed and has an experienced management team. A cost benchmarking exercise showed that the airline is competitive;
- Aurigny's Embraer jet and ATR turboprops are good choices for its UK network compared to other types and the ClearVision technology provided with the new ATRs will provide Aurigny with a competitive advantage;
- The small size of the airline and the operation of three aircraft types in a highly regulated environment means that Aurigny has to carry larger overheads than would be desirable;
- There are opportunities for cost reductions and revenue improvements, including aircraft utilisation and crew rostering, which the STSB has committed to progress with Aurigny;
- Optimising the utilisation of the ATR fleet is an issue which might be addressed by some low frequency flying to new destinations (or revisiting old destinations on a lower frequency basis). The report noted that a key opportunity in addressing the overhead challenge is to increase production (the number of flights) and not increase the staffing;
- Recruitment and retention of staff in Guernsey remains challenging;
- Guernsey needs a realistic, holistic and optimised aviation strategy for the Island.

Secondly, we know that the States continues to expect Aurigny to run its services to Alderney, which in 2018 incurred losses of £2.8m. The States has it within its gift to address this issue by bringing to a conclusion as quickly as possible the PSO process for the operation of those services so that the losses no longer have to be sustained by the airline. The continuing delay in doing so serves nobody well and creates uncertainty for all stakeholders, not least the Alderney community and Aurigny's staff, which makes the ongoing operation of the services in the interim extremely challenging.

Thirdly, we know that in 2018, Aurigny recorded an operating loss of £3.6m. This comprised: firstly, losses of £2.8m on the operation of its Alderney services; secondly, £400,000 in

overdraft interest; and, thirdly, £400,000 attributable to its other UK routes and activities. We also know that, in 2020, Aurigny is forecasting a loss of £9.6m, consisting of: an operating loss of £8.6m and a potential loss of £1m on the disposal of its two classic Dornier aircraft. The increase in operating losses of £5m over this period is accounted for in the table below:

	(£m)	Notes
Revenues - Impact of Open Skies	(3.7)	The net effect on revenues arising from open skies and subsidised competition on the Heathrow route.
Alderney Routes – Projected Improvement	0.3	Pending the results of the PSO process, the Alderney services will move from a 3 to a 2 aircraft operation in 2020.
Introduction of ATR72 series 600	1.1	Projected benefits of: improved reliability; reduced delay & disruption costs; and, reduced maintenance costs.
Movement in Oil Prices	(0.6)	In common with most airlines, Aurigny operates a hedging policy and enters into hedging contracts to deliver predictable costs. The market price for crude oil has increased by approx. 20% between 2018 and 2020.
Sterling/US Dollar Exchange Rates	(0.4)	In common with most airlines, Aurigny operates a hedging policy and enters into hedging contracts to deliver predictable costs. The value of Sterling against the US Dollar has declined by approx. 5% between 2018 and 2020, with a subsequent increase in the costs of fuel and certain maintenance activities, which are charged in US Dollars.
Salaries & Wages	(1.1)	Pay awards in 2019/20; responding to skills retention pressures; training as a result of staff turnover.
Aircraft Maintenance	(0.3)	Maintenance tasks required prior to return of leased ATR42 to lessor.
Other	(0.3)	Net impact of other changes.
Total	(5.0)	

So, we know that the main drivers of the increased operating losses are: net reductions in revenues arising from open skies and competition subsidised by the States on the Heathrow route (£3.7m); movements in oil prices and exchange rates (£1m); and, increased salary and wages costs associated with pay awards, skills retention pressures and additional training costs arising from staff turnover (£1.1m). As the PA Nyras report noted, Aurigny has either no or only partial control over the impact of the Heathrow route, the effect of open skies and the recruitment and retention challenges that arise in maintaining an on-Island workforce and skills base. It has no control over oil prices and exchange rates, albeit it seeks to mitigate the impact of changes here through hedging policies.

Fourthly, we know that as recently as last year, the States agreed to support Aurigny's business case for the purchase, not lease, of new aircraft². That business case was the subject of an independent assurance review by PA Nyras, who confirmed that purchase, rather than leasing, was the optimum approach for Aurigny. An analysis of the pros and cons of purchasing and leasing aircraft was set out in that policy letter and demonstrated that leasing would have been considerably more expensive than purchasing, largely as a result of the low cost of capital that is available to Aurigny with the provision of a States of Guernsey guarantee. I have attached as Appendix 1 to this document a copy of the table included in that policy letter that summarises the associated pros and cons.

Finally, we know that the States is able to exercise control of Aurigny. It does this by the appointment, through the STSB, of the airline's Chairman and Non-Executive Directors and through the establishment of shareholder guidance for the airline, which it has previously reported to the States³. This is reinforced through regular reporting and meetings with representatives of the airline's Board that enable the STSB to formally review, challenge and discuss: strategic matters; financial performance, including management accounts and forecasts; the company's performance against its shareholder objectives and guidance; risk and assurance issues; and, significant operational issues and updates.

The facts as we know them do not support the adoption of the specific measures referred to in these questions. The States can and already does exercise control over Aurigny through an agreed system of governance. The independent report from PA Nyras concludes that the airline is generally well managed. That same report identifies a need to improve utilisation of the airline's fleet through targeted additional flying as a means of addressing the large overhead that it has to sustain, which is at odds with a suggestion that it should dispense with existing routes or be precluded from opening new ones. Aurigny has demonstrated that the leasing of aircraft would be more expensive than purchasing them and its conclusions have been independently verified, which is also at odds with a suggestion that it should sell its existing fleet and lease back what might be required for its future operations.

In summary, the measures suggested will not address the key reasons and drivers for Aurigny's deteriorating financial position set out in the table above and could potentially exacerbate the position.

Question 1d

Also if the answer is 'no', can you tell me please what you think needs to be done and what measures you will be pursuing, in an attempt to resolve Aurigny's astronomical and completely unacceptable annual losses?

Answer

² Article 17 of Billet d'Etat XXVII of 2018: Aurigny Air Services – Aircraft Acquisitions (section 5.2)

³ Article 17 of Billet d'Etat XXVII of 2018: Aurigny Air Services – Aircraft Acquisitions (section 3.1.4)

The first thing that the States can do is to expedite the PSO process for the operation of the Alderney services. The STSB firmly believes that this process is essential in determining once and for all what an appropriate level of service is for those routes and what level of financial support should be provided for them. Importantly, it will mean that any losses that are incurred in operating them in future will no longer fall to Aurigny's profit and loss account, resulting in a substantial and immediate improvement in its performance.

Any measures that might be put in place to address Aurigny's broader financial position need to take account of the wider policy considerations for the States of Guernsey, as well as the uncertainty around the future of the Heathrow service and the very fluid situation in the local market arising from the open skies policy.

Aurigny has historically been mandated by the States to both maintain its existing slot portfolio at Gatwick Airport (up to 6 daily slot pairs) and, more recently, to ensure that it provides sufficient capacity on the route to meet the demands of the London market. This was achieved, with the agreement of the States, through its acquisition of its larger Embraer jet following Flybe's decision to withdraw from the Gatwick market in 2014 after it sold its slots there. The substantial increase in capacity into the market place between the Island and the south-east of England during 2019 as a result of the quasi-open skies policy and the introduction of a subsidised service to Heathrow means that the time is now right for the States to review this mandate. Key considerations will include: how much certainty is there about the ongoing availability of slots for the Heathrow service; and, whether Aurigny should maintain all or part of the existing slot portfolio at Gatwick and, in doing so, what level of capacity should it be providing in the market on that route.

In undertaking any such review, a key consideration will be the Island's requirement for security of supply in the Gatwick market. Under the 80/20 "use it or lose it" slot allocation rules, airlines only have a right to keep their slots at Gatwick from one season to the next if they are used for at least 80% of the time. Any decision to switch services on or off has to be considered within this context and whether or not there is an appetite for Aurigny to sell or lease any of its existing slots to another carrier if it does reduce its service frequencies there.

While the STSB understands that Flybe's new owners have indicated they would like to provide a service between Guernsey and Heathrow in the long-term as part of Virgin's ambitions there, it also understands this is contingent on the construction of a third runway and the necessary slots thereby becoming available. In the meantime, the reality is that the short-term "rolling over" of the Heathrow route arrangement every six months creates uncertainty in the market that hinders Aurigny's ability to plan effectively. That uncertainty is perhaps best illustrated by Flybe's decision to withdraw its services between the Isle of Man and Heathrow with effect from 26th October, having only launched them on 21st April this year.

Therefore, as I have indicated in my response to question 1a, the STSB welcomes the acknowledgement by the P&RC in its 2020 Budget Report⁴ that there are limited options for temporary measures that could be introduced to mitigate the projected losses in any

⁴ Article 1 of Billet d'Etat XXI of 2019: The States of Guernsey Annual Budget for 2020 (sections 8.35 to 8.43)

meaningful way and that the possible long-term consequences of any permanent measures would need to be fully investigated and carefully considered. It fully supports the States' decision to develop a coordinated and coherent government framework for the consideration of all aspects of air route operation and support that is under the control or influence of the States of Guernsey and to report back to the States during 2020. The Budget Report noted that this work will need to consider the likely effects of the revised framework on Aurigny's financial position.

Aurigny has identified a number of potential mitigations that could be put in place and these could involve a reconfiguration of its existing fleet and/or route structure. However, they are each dependent on whether the States continues to expect Aurigny to maintain existing levels of both security and capacity at Gatwick and, if not, what those requirements will be in future. This is because it is the Gatwick operation that drives the fleet's structure and how it is utilised on services there and to other regional points in the UK. As such, these options will need to be considered within the context of the aforementioned framework and the role that it is determined Aurigny should play within it. In the meantime, given the highly competitive market within which Aurigny is operating, it would be entirely inappropriate to disclose those options under consideration to its competitors through the responses to these questions.

Finally, both Aurigny and the STSB are committed to starting work on addressing the recommendations from the Efficiency & Benchmarking Review which highlighted a number of opportunities that could be investigated to reduce the airline's costs, to improve its revenues and continue developing and enhancing its customer service proposition.

Appendices

Appendix 1: Aircraft Purchase and Aircraft Lease – Comparisons (Extract from Article 17 of Billet d'Etat XXVII of 2018)

Date of Receipt of the Question: 10th November 2019
Date of Reply: 22nd November 2019

Appendix 1: Aircraft Purchase and Aircraft Lease – Comparisons (Extract from Article 17 of Billet d’Etat XXVII of 2018)

Aircraft Purchase	
Advantages	Disadvantages
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> • 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.
Aircraft Lease	
Advantages	Disadvantages
<ul style="list-style-type: none"> • 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. 	<ul style="list-style-type: none"> • 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.
<p>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.</p>	

