



XI
2003

BILLET D'ÉTAT

WEDNESDAY, 14th MAY, 2003

STATES ADVISORY AND FINANCE COMMITTEE

SECURITY OF AIR LINKS

BILLET D'ÉTAT

TO THE MEMBERS OF THE STATES OF THE ISLAND OF GUERNSEY

In accordance with the provisions of Article 1(5) of the Rules of Procedure of the States of Deliberation, I have the honour to inform you that a Meeting of the States of Deliberation will be held in **THE SARNIA HALL, BEAU SEJOUR CENTRE, on WEDNESDAY, the 14th MAY, 2003** immediately before the Meeting already convened for that day.

The President
States of Guernsey
Royal Court House
St Peter Port
GUERNSEY
GY1 2PB

12th May 2003

Dear Sir

SECURITY OF AIR SERVICES

Introduction

Guernsey is critically dependent on air links to a London hub airport for the Island's economic and social wellbeing. The loss of direct air services to Heathrow in 1998 was a significant blow to the Island and since that date concern has grown as to the security of services to the only other London hub airport of Gatwick.

As a small Island community, separated by 80 miles of sea from the UK mainland, air services offer 'lifeline' links. Close to three-quarters of trips between Guernsey and the UK are by air. Of these around 30% will be interlining to international destinations.

Air transport is essential for every member of 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. These links are also fundamental to the long term economic sustainability of the Island. The finance industry represents well over 60% of the Island's GDP and has identified good air links into one of the two principal London hub airports as a major factor in the long term success of the sector, not least because of the very close relationship with the City of London. 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.

Hub access to Heathrow or Gatwick, as opposed to access to airports such as Stansted or London City, is crucial to Guernsey.

Firstly, it enables air services to carry both point-to-point traffic and connecting passengers, thereby making services viable that might not otherwise be offered. Whilst with a population of just 60,000, the Island can support a high capacity and daily frequency of air service on routes to the London hub airports, a similar level of service could not be sustained to other airports within the United Kingdom, or in mainland Europe. By maintaining a connection to a London hub airport, local passengers, businesses and tourists therefore benefit from both a greater frequency of services and a greater number of potential destinations.

Secondly, access to a London hub is vital because, as the finance industry in particular highlights, businesses based in Guernsey need wider international access. Despite Guernsey's relative proximity to the European mainland and the UK, the Island is rendered geographically remote without air links that match the Island's needs.

In view of the above considerations, the prevention of the potential loss of the Islands' slots into Gatwick, currently provided by Flybe and British Airways, has been identified as a major priority by the Transport Board and the Advisory and Finance Committee for some years.

Demand for Slots at London Hub Airports

The commercial environment in which airlines operate militates against short haul services to relatively small communities such as those of the Bailiwick. The underlying trend in air travel worldwide has increased demand for limited landing slots at the London hub airports making these slots an extremely valuable commodity in themselves. The profit that can be generated from a landing slot when used for a wide bodied jet operating a long haul service is far in excess of what can be generated from the small aircraft running services to the Bailiwick.

The problem faced by Guernsey, like the UK peripheral regions, is that commercial airlines cannot be expected to take into account the public good that air links provide. From a public policy perspective, it can only be assumed that airlines will act in their commercial self interest. Therefore as the value and pressure on slots increases, so too does the vulnerability of Guernsey's 'lifeline' into Gatwick.

Regulatory Solutions

The Guernsey Transport Board has in coalition with Jersey, through submissions to the United Kingdom Government and Parliament, highlighted the importance of air links into London hub airports for the Island. In particular, the Board has called on the UK Government to lobby in the European Union to amend the current regulations to allow the reservation of slots for regions.

The Department of Transport has taken a more positive stance with regard to the need to protect the Island's slots in recent months. This somewhat revised position is in large part due to an acknowledgement by the UK Government that the UK's own regions are seriously concerned about loss of vital air access into London hub airports.

However, a regulatory solution to give the UK Government the power to safeguard the maintenance of slots on a route between Guernsey and a London hub airport is dependent upon agreement in the EU to amend current regulations. At present the only possible option is for the revision of E.C. Regulation 95/93 on the Common Rules for the Allocation of Slots at Community Airports. The Regulation has been under review since June 2001 by the European Commission. Notwithstanding extensive lobbying by the Guernsey Transport Board of both the UK Government and the European Commission to have the Regulation amended this has been to date unsuccessful. Consequently there is no legal mechanism through which the Bailiwick can seek to protect its position at London hub airports.

Increase in Capacity

The UK Government has predicted that passenger movements at UK national airports will double in the next 20 years, and could be around triple current levels by 2030. Although the market is currently depressed due to the effects of September 11 and uncertainty following the second Gulf war and SARS in Asia, the longer term underlying trend in air travel worldwide is increasing.

The UK Government has accepted the economic imperative to increase capacity at UK airports, and particularly into the South East. In July 2002, the UK Secretary of State for Transport launched seven Regional Capacity Studies, looking at future air transport capacity needs in each region and examining possible solutions through either additional runways or airports.

The Transport Board responded to the South East consultation last year, and called for at least one new runway to be built at each of the three major London airports of Gatwick, Heathrow and Stansted. However, it has to be recognised that whatever option the UK Government eventually favours, it will take at least ten to fifteen years before the additional capacity will feed through. Consequently, the pressure on slots into London hub airports in the short to medium term can only increase.

Withdrawal of British Airways Gatwick Route

Against a background of rumours and speculation, at the beginning of this month the Advisory and Finance Committee was made aware that British Airways (BA) intended to make an imminent announcement that, with effect from 15 June 2003, it was withdrawing Gatwick services to and from the Island currently operated alongside those of Flybe. In 2002, BA were responsible for approximately 108,000 passenger movements on this route which represents about 35% of the total traffic. The Committee was also advised that BA was in discussion with Aurigny Air Services

Limited (Aurigny) on exchanging Gatwick slots so that Aurigny could provide continuity of service. As a result of BA's prior failed negotiations with another potential operator, the slots available for the remainder of the current summer season are more limited than those presently operated.

The Committee recognises that BA acted honourably in seeking to ensure continuity of service. However, the Committee regrets BA's decision to withdraw its service and the short notice received. The timing of the withdrawal of the service at the start of the visitor season and just days before the official opening of the Island Games places an obligation on the States to take swift and decisive action.

Discussions with Aurigny

At the same time as hearing of BA's intention to withdraw from Gatwick services the Committee was approached by Aurigny with regard to a potential funding relationship in order to enable the immediate continuation of the Gatwick service in a manner that would also provide the Island with long term security as regards its key links to a major London hub airport.

The initial approach by Aurigny was made to the President of the Transport Board but in view of the Board's role as a licensing authority discussions were immediately transferred to the Advisory and Finance Committee. Of the members of the Transport Board only the President has had any involvement in the discussions with BA or Aurigny and as a result he will not be involved in any licensing issues arising from the matters contained in this policy letter.

The Committee approached its discussions with Aurigny and its shareholders¹ on the basis of the possibility of the States providing financial support through partnership funding to enable the company to finance the working capital necessary to sustain the Gatwick operations. In return, the Committee was seeking assurances as to the long term security of access into Gatwick.

However, early in the discussions, the Committee was advised that the shareholders of Aurigny were not prepared to operate in partnership with the States or to contribute the additional funds necessary to take over the Gatwick services and operate them using the less frequent and less attractive slots for the remainder of the summer period. It should be noted that the full number of slots, allowing 4 return flights a day at the most convenient times, and therefore more attractive to customers, will become available again by the winter 2003 schedule.

¹ It should be noted that Close Investment Partners Ltd, acting in its capacity as general partner for a series of investment funds is holder of 63% of the issued share capital in the company.

The shareholders of Aurigny were however prepared to discuss the sale of the company to the States so that the States could ensure the continuing operation of the former BA Gatwick services alongside the other existing services operated by Aurigny.

The Advisory and Finance Committee considers that this current situation presents the Bailiwick with a unique opportunity not only to avoid the service disruption that would otherwise be caused by the imminent withdrawal of BA's flights into Gatwick but also to secure essential services into a London hub airport by the purchase of Aurigny. For the reasons outlined above, protection of these services through regulation or increased capacity in the UK are at best only medium to long term solutions and may never happen. This purchase option is the only solution available in the short term and there is a limited window of opportunity because if Aurigny does not take up BA's offer to exchange its slots into Gatwick the slots will go into the pool for re-allocation.

Aurigny also has a long history of serving the Bailiwick on the essential inter island routes which also need to be safeguarded and is an airline of a size, and hence value, that the States is able to contemplate purchasing. Additionally, the offered price for Aurigny reflects the present, probably short term, depressed state of the worldwide air travel market.

Against the strategic benefit to the Island of securing access to Gatwick, the Committee recognises that there are potential downsides to the States purchasing an airline.

Safeguards must be put in place to ensure that there is no conflict between the States role in licensing air routes and having an interest in an airline.

A management structure must also be set in place to ensure that political influence is not exercised to operate the company on other than commercial lines. Such political interference could damage the commercial viability of the airline and result in unsustainable losses.

Additionally, even without political intervention, there are in any case commercial risks associated with owning an airline. The aviation business is notoriously volatile and susceptible not only to economic factors but also to public and market perceptions.

It should further be noted that the regulatory environment, under which Aurigny will continue to operate as an airline, is governed not by the States but by the EU and UK authorities.

Despite these potential risks, the possible acquisition of Aurigny is an opportunity for a strategic investment in a commercial operation that will be of considerable value in protecting the Island's long term social and economic sustainability. The Committee therefore concluded that the long term advantages of securing access to a London hub airport greatly outweighed any potential downsides and in consequence agreed to enter into discussions with the owners of Aurigny for its purchase.

The Committee has consulted HM Procureur and has ascertained that there is no reason in law preventing the States from making this acquisition.

Outcome of Discussions with Aurigny

The outline of an agreement reached with Aurigny on 8 May 2003 is given below:

- To secure an option to purchase and to demonstrate serious intent a sum of £150,000 has been paid to the vendors, which is non refundable in the event that the States does not purchase the company but is part of the total consideration if the States agrees to the purchase;
- Aurigny must have secured a legally enforceable right to appropriate slots to operate Gatwick services to and from the Island. (This condition has now been fulfilled by an exchange of correspondence between BA and Aurigny);
- A new holding company, Cabernet Limited will own at the time of completion 100% of the capital in the two operating companies: Aurigny Air Services Limited and Anglo Normandy Engineering Limited. This latter company contracts for aero engineering works worldwide but is also essential to the activities of Aurigny Air Services Limited in the servicing of the fleet of aircraft which it operates.
- The States will also acquire 100% of the equity of Leasair International Limited, a dormant UK company which holds a lapsed UK Air Operators Certificate.
- For a sum of £5 million the States will acquire 100% of the equity of Cabernet Limited which through the operating companies will give the States full control of all of the assets, staff, rights and permissions necessary to continue to provide the existing services operated by Aurigny and the new Gatwick services. For this sum the States will acquire the group of companies free of any outstanding debt other than in respect of the normal trading operations of Aurigny Air Services Limited and Anglo Normandy Engineering Limited.

Within the limited time available the Committee has employed appropriate specialist advice and undertaken accounting and legal due diligence exercises on the company which has not brought to light any matters of serious concern. Discussions have already been undertaken with key staff to reassure them about their long term future with the company. In the short time of the negotiation, the Committee has been extremely impressed by the quality, enthusiasm and openness of the senior management of the company and the quality and accuracy of its management information.

It must be recognised that in addition to the direct cost of acquiring the company, there will be a need to provide guarantees or loans to cover the initial funding necessary to continue operating the Gatwick services particularly when using the less frequent and less convenient slots prior to the winter schedule. The Committee estimates that this

will require either a cash injection from the States or a guarantee for commercial borrowing in the order of £1-2 million.

It is important to note that this acquisition is not the same as taking an existing States entity with a public service culture and practices and seeking to turn it into an arms length commercial operation as was the case with the commercialisation of Guernsey Post Ltd for example. Aurigny is already a company with a commercial culture and practices. As far as the staff in general are concerned there will be no change to their employment arrangements as a direct result of the change in ownership. They will not become States employees.

It is for future consideration as to whether in the long term the States should retain 100% ownership of Aurigny or consider the involvement of other equity partners whilst retaining majority control or some kind of 'Golden Share' to protect the Island's strategic interests. The Committee believes that such consideration must come after the immediate need to take the strategic decision to acquire Aurigny and protect the Gatwick service. A period of consolidation will also be necessary in order to establish the Gatwick operation which will itself be a major challenge for the company.

The Advisory and Finance Committee intends that the two shares in Cabernet Limited will be held in trust for the States, one each by the President and Vice President of the Committee and that the shareholder role should be exercised as directed by the Committee. The Committee would intend, at a General Meeting to be held immediately after the States' purchase of the holding company, Cabernet Limited, to appoint as executive directors of that company the current Chief Executive, Mr M Hart, Group Finance Director, Mr P O'Donovan and Commercial Director, Mr M Coupar.

It is further intended, as an interim measure, that the President of the Advisory and Finance Committee will be appointed as Chairman of the company. The Vice President of the Advisory and Finance Committee, Deputy J E Langlois and Mr S M Jones will be appointed as non executive directors. Deputy Langlois has in the past served in a private capacity as a director of Aurigny Aviation Holdings Limited and so has experience of setting strategic objectives of the operating companies. Mr Jones was employed to assist the Committee in negotiating the agreement with the owners of the company and his local business experience will be extremely valuable to the company. The CVs of the executive directors and Mr Jones are attached as an Annex to this policy letter.

It is further intended that Mr Jones and the three executive directors of the holding company will be appointed as directors of the operating companies which will be obliged to work within the broad policies set by the holding company, and hence the shareholders. There will thus be no direct political involvement in operations. The Committee consider such arrangements necessary in order to ensure the freedom of the operating companies to act fully commercially and the ability of the States to maintain the level of independence necessary to carry out its functions as a licensing authority.

The Committee undertakes to review the appointment of the Chairman and non executive directors of the holding company and to report back to the States by the end of the year.

Funding the Purchase of Aurigny

Under the agreement reached for the purchase of the company the States will need to make an immediate payment of £5 million. Furthermore, as stated above it is likely that it will be necessary for the States to make a cash injection, or to guarantee commercial borrowing to provide operational funding for the continuing costs of the Gatwick service.

The money to fund this strategic investment will come from the General Revenue Account cash deposits which are maintained by the States to fund day to day expenditure. Since the purchase of the company and its underlying commercial activities is an investment, it will be treated as such and shown in the States accounts in a similar manner to the States investment in Guernsey Post Ltd and Guernsey Electricity Ltd. Hence, if this strategic acquisition is approved by the States it will not directly affect the Capital or Contingency Reserves.

Summary and Recommendations

The withdrawal of BA services from Guernsey to Gatwick is a dramatic illustration of the Island's vulnerability to commercial imperatives. Access to a London hub airport is vital to the Island's economic and social sustainability. The options of regulatory protection or increased capacity in UK airports to give the Island greater security of access to a London hub airport are only available in the medium to long term at best. It is only by agreeing to the proposition set out below that the States have the opportunity to immediately ensure security of access to Gatwick. This access has long term strategic benefits for the Island.

The Committee believes that this proposal is in the overwhelming public interest and recommends that the States accordingly approve the recommendations as set out below.

1. To authorise the Advisory and Finance Committee to take all such actions as may be necessary or appropriate to acquire Cabernet Limited being the holding company of Aurigny Air Services Limited and Anglo Normandy Engineering Limited for a total consideration of £5 million.
2. To authorise the Advisory and Finance Committee to pay the associated professional, legal and technical fees incurred in investigating and facilitating the above acquisition out of its existing budget.

3. To authorise the Advisory and Finance Committee on behalf of the States of Guernsey to provide loans or enter into any commercial guarantees or underwriting arrangements, with terms and conditions as it may determine and consider appropriate, in order to secure the continuing operation of services to Gatwick.
4. To direct the Advisory and Finance Committee to report to the States on the exercise of any actions taken under (3) above, as appropriate.
5. To note the intention of the Advisory and Finance Committee to secure the appointment of Directors as set out in this policy letter.

Yours faithfully

L. C. MORGAN

President
Advisory and Finance Committee

CURRICULA VITAE

Malcolm Hart - Chief Executive

Having graduated with a BA (Honours) in Business Studies in 1983, he joined Air Ecosse Limited in Aberdeen as Assistant Accountant. Transferred to the parent company Fairflight Limited in 1985, fulfilling various finance roles, and was appointed Chief Executive of the Group in 1988. With his two majority shareholders, became one of the owners of Gill Aviation Limited in 1989 when the airline was purchased for £1. Took a consultancy role with the business following its sale for £5.5million in 1995 and was re-appointed as Managing Director in 1996 following the failure of the previous management team. Left the Company in August 1999 and became Managing Director of Aurigny Air Services in May 2000. Was appointed CEO of the Aurigny Anglo Group in January 2001.

Peter O'Donovan - Group Finance Director

Peter qualified as a Certified Accountant and was admitted to fellowship in 1981. Following several years in a high tech manufacturing environment he left to join Bell & Howell, a worldwide manufacturer and distributor of audio visual equipment. After two years as UK Financial Accountant he was promoted to become European Financial Controller responsible for the accounting functions in 9 European subsidiaries, reporting to the headquarters in the USA.

In 1987 Peter moved to Guernsey, joining the worldwide headquarters of Insituform Group Limited as Group Chief Accountant. In this role Peter was responsible for the control and consolidation of the Group companies and the full Group reporting requirements of the North American Stock Exchange.

Peter joined Aurigny in 1994 initially as Group Chief Accountant and has progressively taken on more senior roles and is now Finance Director for the Group and all subsidiary companies.

Malcolm Coupar - Commercial Director

Malcolm joined Dan-air in June 1987 as Operations Assistant after completing 4 Higher Grades at Aberdeen Grammar School. Joined Air Ecosse in 1982 as an Operations Controller and progressed to the position of Assistant Commercial Manager. He joined Connectair in London Gatwick as Commercial Executive quickly became Commercial Manager. In 1989 Connectair was sold to the International Leisure group and rebranded as Air Europe Express, where he remained in the position of Commercial Manager.

In 1991 following the collapse of the International Leisure Group he formed part of the management team which founded CityFlyer Express, initially as Commercial Manager until appointed to the Board as Commercial Director in 1993. From a start in 1991 with Capital of £1.75m (primary funding from a 3i's lead syndicate) the business developed into Gatwick's second largest carrier in terms of slot holding, and was sold to British Airways in 1999 for £75m.

Malcolm joined Aurigny as Commercial Director in April 2003.

Stephen Jones – Non Executive Director

Stephen Jones, age 51, has recently retired as Island Director of Barclays Bank PLC. He worked in the finance sector in Guernsey for over 25 years and was Managing Director of Woolwich Guernsey Limited for 12 years. He was Chairman of the Guernsey International Business Association until April 2003, a past Chairman of the Association of Guernsey Banks and the first Chairman of the Guernsey Promotional Agency.

Stephen is a non-States Member of the Board of Industry and a member of the Douzaine in St Martins. He is also a Council member of the Institute of Directors. He has considerable experience as a non-executive director in a variety of businesses and is currently Chairman of Securicor Guernsey Limited and Heath Lambert Insurance Management (Guernsey) Limited.

The States are asked to decide:-

Whether, after consideration of the Report dated the 12th May, 2003, of the States Advisory and Finance Committee, they are of opinion:-

1. To authorise the States Advisory and Finance Committee to take all such actions as may be necessary or appropriate to acquire Cabernet Limited being the holding company of Aurigny Air Services Limited and Anglo Normandy Engineering Limited for a total consideration of £5 million.
2. To authorise the States Advisory and Finance Committee to pay the associated professional, legal and technical fees incurred in investigating and facilitating the above acquisition out of its existing budget.
3. To authorise the States Advisory and Finance Committee on behalf of the States of Guernsey to provide loans or enter into any commercial guarantees or underwriting arrangements, with terms and conditions as it may determine and consider appropriate, in order to secure the operation of the additional services to Gatwick.
4. To direct the States Advisory and Finance Committee to report to the States on the exercise of any actions taken under 3 above, as appropriate.
5. To note the intention of the States Advisory and Finance Committee to secure the appointment of Directors as set out in that report.

DE V. G. CAREY
Bailiff and President of the States

The Royal Court House,
Guernsey.

The 12th May, 2003.

IN THE STATES OF THE ISLAND OF GUERNSEY

ON THE 14TH DAY OF MAY, 2003

The States resolved as follows concerning Billet d'Etat No. XI
dated 12th May, 2003

STATES ADVISORY AND FINANCE COMMITTEE

SECURITY OF AIR LINKS

After consideration of the Report dated the 12th May, 2003 of the States Advisory and Finance Committee:-

1. To authorise the States Advisory and Finance Committee to take all such actions as may be necessary or appropriate to acquire Cabernet Limited being the holding company of Aurigny Air Services Limited and Anglo Normandy Engineering Limited for a total consideration of £5 million.
2. To authorise the States Advisory and Finance Committee to pay the associated professional, legal and technical fees incurred in investigating and facilitating the above acquisition out of its existing budget.
3. To authorise the States Advisory and Finance Committee on behalf of the States of Guernsey to provide loans or enter into any commercial guarantees or underwriting arrangements, with terms and conditions as it may determine and consider appropriate, in order to secure the operation of the additional services to Gatwick.
4. To direct the States Advisory and Finance Committee to report to the States on the exercise of any actions taken under 3 above, as appropriate.
5. To direct the States Advisory and Finance Committee to report to the States on any necessary or desirable changes to the regulation and licensing of air services by the Transport Board.
6. To note the intention of the States Advisory and Finance Committee to secure the appointment of Directors as set out in that report.

**K. H. TOUGH
HER MAJESTY'S GREFFIER**