

Grwp yr Economi, Sgiliau a Chyfoeth Naturiol
Economy, Skills and Natural Resources Group
Cyfarwyddwr Cyffredinol - Director General



Llywodraeth Cymru
Welsh Government

Nick Ramsay AM
Chair – Public Accounts Committee
National Assembly for Wales
Cardiff Bay
Cardiff
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24 February 2020

Dear Chair

CARDIFF AIRPORT

I am responding to your letter of 14 January in relation to the above. I understand you have kindly agreed to accept this response in lieu of receiving a separate evidence paper in advance of a further scrutiny session with Welsh Government officials on this subject, which is being arranged to take place in March.

Firstly, I am sorry for any confusion caused by use of the “Commercial in Confidence” marking on my previous letter. While this is an appropriate precaution to take in relevant circumstances, we recognise much of the high level information contained in my previous letter is in the public domain in one form or another. While we were carrying forward work under that protected heading, I agree use of the Commercial in Confidence marking in that specific instance was unnecessary.

Loan Facility

As you know, at the end of 2019, the Minister for Economy and Transport agreed to provide an extended commercial loan facility to the airport of up to £21.2m. The loan refinancing will ensure Cardiff Airport (CIAL) is well placed to continue investing in areas like the airport buildings and infrastructure, its route development, and necessary upgrades to maintain regulatory compliance with changing standards in baggage screening and border security. For example, during 2022-23, CIAL will need to invest an estimated £5m to meet UK-wide regulatory change in the next generation of security screening. The loan will also likely contribute towards essential runway maintenance and resurfacing during 2023-24, to ensure compliance with mandatory regulations. This work is estimated to be in the region of £4-5m. On average, CIAL has invested around £3-4m each year on its infrastructure, which should continue for the foreseeable future. The above provide examples of potential spend for the loan funds. However the loan agreement provides flexibility for the airport to use the money for: refinancing the existing [2017] loan and the accrued interest [associated with the 2017 agreement]; route development activities for new and existing carriers and capital expenditure in accordance with priorities identified in the Business Plan; general business purposes; and

the payment of fees. However the loan agreement does not specify how the money will be split – this is a matter for the airport, and its business planning and operational priorities. The loan to Cardiff Airport is commercial in nature and, as such, the Airport is not obliged to report to either our Agent (the Development Bank for Wales) or Welsh Government (as the loan provider) with specific details as to how the funding is used. That being said, officials will be asking Cardiff Airport for six-monthly progress reports on spend and impact. It is worth noting that CIAL requested a total additional loan value of £28m. Only the first 2 years at a value of £21.2m have been approved to date. The remaining £6.8m requested by CIAL is subject to approval, with supporting additional analysis and financial due diligence.

The loan refinancing was offered on a commercial basis and is repayable in full, with an interest rate which is assessed annually and was in line with the EU reference rate of 1.09% (as at loan execution). The loan began in September 2019 and the agreed £21.2m is estimated to be drawn down over the first two years of the agreement. Any further funds are subject to additional approvals and would be expected to be drawn down between 1 April 2020 and 31 March 2025. The first repayment is scheduled for 31 March 2026. The next repayment is not due until 31 March 2030, and then CIAL must provide an agreed repayment every year on 31 March until the final repayment date which is 31 March 2044.

Whilst the values of repayments are commercially sensitive, I can confirm that an agreed repayment schedule, with agreed values, has been identified within the loan agreement. Interest is charged from the first drawdown and to date, of the additional £21.2m, CIAL has drawn down £16.4m in line with expectations. In accordance with the loan agreement, the first drawdown of the extended loan facility was made at the start of the agreement, which was required in order to repay the previous loan facility along with the accrued interest. CIAL's financial performance and the extended loan facility will continue to be monitored by the Development Bank of Wales, in order to provide external independent professional assurance and monitoring for the term of the loan. Holdco also continues to undertake its internal governance through ongoing dialogue and regular formal meetings with the airport's Board of Directors. CIAL produces a refreshed business plan annually which contains a one year budget, two year operations plan, five year forecast and 25-30 year projection. The current plan was approved in March 2019 by Holdco and was used by Oxera in its analysis in relation to the recent loan application.

External economics and State aid consultancy, Oxera Consulting LLP, led on the analysis along with appropriate accountancy experts for the financial due diligence which provided a recommendation to Ministers to agree the loan refinancing with CIAL. A range of factors were considered in the scope of works, which included:

- CIAL strategy and business plan;
- short and long term traffic forecasts;
- market position and service offerings;
- current market environment for airport operators with similar characteristics to CIAL;
- terms and conditions of recent financings in the airport sector (to the extent possible);
- potential areas of uncertainty;
- development of plausible downside and upside scenarios;
- historic and forecast trading;
- market appraisal;
- profit and loss, balance sheet, cash flow, revenues and financial assumptions;
- CIAL's market position and credit rating;
- industry changes and financing models for other airports;
- serviceability of existing and proposed debt;
- suggested covenants/protectations;

- funding structure and repayments; and
- sensitivity analysis.

It is important to acknowledge that the airport operates in a UK aviation market which is inevitably skewed in favour of large commercial airports, in areas of high population and relative prosperity. You will recall from the earlier PAC evidence session that the UK's presumption of private airport ownership runs counter to the international approach - of the 4,300 global airports which service scheduled flights, only 14% are not in public ownership. Airports such as Charles De Gaulle in Paris, Schiphol in Amsterdam and JFK in New York are publically owned. Smaller airports are also disproportionately impacted by the very necessary but expensive costs of safety and security regulations, which restricts what we are able to do, as Government, to financially support the airport. In mainland Europe, governments recognise this burden and provide direct financial support in order to ensure that communities served by regional airports do not lose out. The UK Government's interpretation of European regulations means that such support in the UK would, in its view, constitute State Aid and is therefore not permitted.

You will appreciate that CIAL operates in a highly competitive, unpredictable and commercially sensitive environment. I have therefore asked the CIAL team to respond to any further commercially sensitive queries PAC might have, to the extent that they are able, during their evidence session on 2 March.

CIAL Accounts

Since the Welsh Government purchased the airport in 2013, our ambition has been to secure the future of this vital transport gateway for Wales, and our focus has been to build the long term sustainability of the business and strengthen its financial position. The acquisition of CIAL in 2013 was intended as a long term investment to contribute positively to the Welsh economy. It is the Welsh Minister's continued vision that CIAL remains under majority public ownership for the long term, however we remain open to considering equity investors whilst ensuring Welsh Ministers retain the controlling share in order to protect the airport's future success.

CIAL is an important piece of strategic transport infrastructure, and a key economic asset for Wales. Whilst the airport's growth has not yet reached the levels initially forecast at acquisition in 2013, we remain satisfied with its overall progress despite the significant challenges (such as Brexit) faced by the industry in the last few years. The airport has increased its passenger numbers by over 65%, and last year it attracted almost 1.7 million passengers, of which, on average over 30% of passengers who travel through CIAL are visitors to the country. In addition, the airport has a direct, positive impact on our economy. In 2018, it had a total GVA footprint of £246m and it also sustains around 2,400 aviation-related jobs directly and indirectly in South Wales.

During the 2018-19 financial year, the airport has seen a growth in commercial revenue by over 34% as a direct result of the improvements made to enhance the customer experience. On 27 December, CIAL published its accounts for the 2018-19 financial year. Whilst the media picked up on various points in comparison with the previous year's accounts, the key focus for proper comparison is EBITDA (earnings before interest, tax, depreciation and amortisation). For the second year running, the airport has returned a positive EBITDA which is a measure of a company's operating performance and the key metric by which airports are valued globally. The EBITDA for CIAL has increased with continued growth forecast for this current financial year.

In order to better secure its future, CIAL has invested in its operations and diversified its business model, which recently included taking over the operation of the Bro Tathan airfield. At the end of 2019, it was also contracted by the Isle of Anglesey Council to take over the remote operation and management of Anglesey Airport's passenger terminal facility; bringing with it a wealth of knowledge and experience, whilst continuing to support the Cardiff-Anglesey air link. It has increased its headcount by over 9% to meet the growing business demands and brought forward its commitment to pay at least the Real Living Wage to all CIAL employees – these social benefits have, as expected, had an impact on the airport's bottom line.

In light of continuing volatility and uncertainty in the global economy – evidenced in the aviation industry by recent airline failures – CIAL reviewed the life over which it measures its intangible assets, in line with normal business practice, and took the prudent decision to write down the value of these assets. This has resulted in an exceptional, one-off charge of £9.3m which is reflected in its accounts for the financial year that ended March 2019.

Airports are viewed as strategic, long-term investments by investors and tend to be held for periods of 25 to 50 years. Our position with CIAL is very much in line with this approach. Regional airports in particular require finance to develop and it is normal practice for this to be in the form of long-term debt. Within the UK, it is common for airports and their holding companies to have significant levels of borrowing, frequently in excess of £100m and in many cases more. We are confident that when the airport exceeds 2 million passengers per annum (which based on the current forecasts is predicted for 2025), the financial performance will be improved and we anticipate at this point that the borrowing levels of the airport will lessen, as profitability and market value (EBITDA) increases.

CIAL: A UK Centre for Low Carbon Aviation

The aviation sector is facing increasing pressure to do more when it comes to climate change and this responsibility does not solely rest with the airlines. As airports expand, so too do their carbon footprints, with more energy required to power new terminals, ground transport vehicles and the creation of infrastructure. Many airports across the world have therefore adopted greener elements into their designs and operational strategies, as well as subscribed to eco-friendly initiatives. The Airport Carbon Accreditation programme, run by Airports Council International (ACI), is helping more than 200 airports to manage their emissions, with the ultimate goal of carbon neutrality.

In April 2019, the Welsh Government declared a climate emergency, shortly after publishing Low Carbon Wales which sets out our ambition to bring forward a target for Wales to achieve net zero emissions no later than 2050. In September 2019, CIAL launched its Environmental Flight Path which was developed with the support of the CIAL Board, the Welsh Government, the Airport Operators' Association and WSP consultancy. It is a framework developed to track environmental and sustainability successes that have already been achieved, whilst setting out immediate short term goals.

In December 2019, the Minister for Economy and Transport agreed to explore the potential of CIAL becoming a UK centre for low carbon aviation and a hotspot for attracting economic development. A strategic outline business case will be prepared by the end of summer 2020 to define the scope to deliver the vision and its outputs and deliverables along with outline costs, risks and timescales.

Flybe

Flybe is one of a number of regional airlines which operates from Cardiff Airport. It currently operates eight routes (two of which are operated during winter months only) and attracts between 320k and 340k passengers in a 12 month period. It has contributed significantly to the passenger growth at the airport over the last few years and, whilst difficult to quantify, its presence at Cardiff Airport provided the catalyst for attracting new airlines such as Qatar (which operates our first long haul route to the Middle East), along with the strengthening and increases in capacity offered by other regional air operators. For example, TUI recently announced an additional 30,000 seats to its summer 2020 timetable.

Following the publically reported financial difficulties in January, we maintained regular dialogue at senior level with the Department for Transport and Cardiff Airport, and we warmly welcomed the rescue deal that was agreed between the airline and UK Government.

In terms of the impact on Cardiff Airport of an operator like Flybe ceasing to trade, this would be an operational matter for the airport, and would be discussed in confidence between the airport and Holdco. However, I would anticipate a scenario such as the withdrawal of an operator to be reflected in the airport's annually adjusted business plan. In terms of the recently agreed extended commercial loan facility, I would like to reassure the Committee that a range of downside scenario models were included within the financial due diligence which informed our decision to award the loan – these scenarios included a “catastrophic event” resulting in significantly reduced traffic for an extended period, and a significant operator stopping its operations at CIAL.

As you know, Welsh Government officials are not involved with the commercial operations of the airport or the relationships with the airlines that operate there. As such any incentives, fee regimes or agreements, with any airline, would be a commercially confidential matter between the airport and operator. May I suggest that the Committee raises these points with the airport directly during the scheduled evidence session on 2 March?

Airlines, APD and Regional Connectivity

Following the significant difficulties faced by regional UK airlines over the last 12 months, the recent agreement reached between the UK Government and Flybe is welcome as it secures the ongoing operation of the airline, allowing it to continue to operate as usual at CIAL. The recent issues with Flybe, following the collapse of Thomas Cook last year, are clear demonstrations that there are significant issues with the stability of regional airline operators and the future of our domestic and short haul aviation markets. We continue to urge the UK Government to intervene further in supporting the future of our small, regional airports, and very much look forward to officials being able to meaningfully participate in the UK Government's review of regional connectivity (including aviation). Ministers also look forward to HM Treasury's review of Air Passenger Duty (APD) prior to the March budget. These issues are of critical importance to the Welsh economy and we will continue to engage with the UK Government on them.

As discussed during previous evidence sessions, the Minister for Economy and Transport has also written to the UK Government a number of times regarding the introduction of a network of domestic Public Service Obligation (PSO) air routes from Cardiff, along with the devolution of APD to Wales. In addition, we have had an initial discussion with the Department for Transport and have asked that, in relation to the review of regional connectivity, the UK interpretation of State Aid rules and Public Service Obligations must be included. We received a positive response to this and now await the terms of reference.

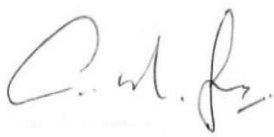
Novel Coronavirus (Covid-19)

Although the Committee has not specifically asked for information relating to the potential impact of Novel Coronavirus (Covid-19), we thought it would be helpful to confirm that Welsh Government officials are in close contact with CIAL as the situation continues to develop. CIAL is receiving regular updates directly from the relevant authorities and is closely following the guidance provided. The safety and security of the CIAL team and its customers is, of course, a priority.

I look forward to discussing these matters further with the Committee during the evidence session in March.

With best wishes.

Yours sincerely

A handwritten signature in black ink, appearing to read 'A. Slade', written in a cursive style.

Andrew Slade
Director General
Economy, Skills and Natural Resources Group