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Archwilydd Cyffredinol Cymru
Auditor General for Wales

Welsh Government Acquisition and Ownership of Cardiff Airport

WALES AUDIT OFFICE
SWYDDFA ARCHWILIO CYMRU

I have prepared and published this report in accordance with the Government of Wales 2006.

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1 Cardiff International Airport (the Airport) was constructed in 1942 as an airfield for the Royal Air Force and has provided a terminal for commercial aviation since 1952, when the first passenger service began flying to Dublin. British Airways Maintenance Cardiff established a base for maintaining long-haul aircraft at Cardiff Airport in the 1980s. The Airport was owned by various public authorities until 1995 and was operated between 1986 and 1995 by Cardiff International Airport Ltd (CIAL), a company owned by a consortium of local authorities in South Wales. The Airport was privatised in 1995 when the local authorities sold CIAL to the TBI Group. The TBI Group was itself acquired by the Spanish infrastructure group Abertis Infraestructuras SA (Abertis) in 2005[1]. As a result of that acquisition, Abertis became the new owner of the Airport as well as two other airports owned by TBI (Luton and Belfast International).

2 In December 2012, the First Minister announced that the Welsh Government was entering formal negotiations with Abertis about the purchase of the Airport. In announcing the negotiations, the First Minister stated that the purchase would 'enable us (the Welsh Government) to develop a more coherent approach to our national infrastructure planning, and integrate the Airport into our wider economic development strategy'. The Welsh Government had been concerned for some time about the performance of, and Abertis' level of investment in, the Airport and the impact on the Welsh economy and Wales' international business reputation. There was no obvious risk of closure, at least in the short term. The Welsh Government was concerned, however, that the Airport might be run down to such an extent that it would no longer be commercially viable and would then close, putting jobs at risk and leading to the loss of a vital national asset.

3 The Welsh Government has emphasised to us that considerations of public policy and economic development were the primary drivers behind the acquisition of the Airport. Nevertheless, commercial considerations were relevant, as were compliance issues associated with the market economy operator principle[2]. Welsh Government officials consider that informed decisions were taken about the acquisition, with all the necessary evidence provided. The due diligence work commissioned by the Welsh Government in advance of the final acquisition included an assessment of the strategic context for the acquisition, which summarised the risks and benefits of buying the Airport compared with the 'do nothing' option. The valuation work commissioned by the Welsh Government included an estimation of the value of the Airport as a public asset, alongside a range of commercial valuations.

4 The Welsh Government purchased the Airport on 27 March 2013 for £52.0 million, to operate at arm's length from Ministers. The deal involved:

a Buying the entire issued share capital of CIAL from Abertis (via TBI) to gain 100 per cent ownership of the equity interest in the Airport.

1 TBI was wholly owned by Airport Concessions and Development Ltd (ACDL), which was 90 per cent owned by Abertis Infraestructuras SA and 10 per cent owned by AENA Desarollo Internacional, a Spanish airports group.

2 European state aid rules require that a public authority that buys a commercial business interest must be able to provide reasonable evidence that it has done so on a commercial basis, paying no more than a hypothetical private investor making a long-term investment. This is known as the market economy operator principle. The European Commission may order any excess value to be recovered from the beneficiary (the seller of the business) if it establishes that the state aid has given an unfair advantage to the beneficiary and so distorts or threatens to distort competition.

b Acquiring this interest on a ‘nil cash - nil debt’ basis, with Abertis (via TBI) retaining cash and writing off a loan to CIAL.

c Establishing a holding company (known as WGC Holdco) as the vehicle by which the Welsh Government owns the shares and oversees CIAL.

d Providing a £3.3 million cash injection to CIAL after completion of the purchase to provide working capital for the company, which was subsequently converted into share capital. This raised the total cost of the investment to £55.3 million.

5 On behalf of the Auditor General, Wales Audit Office staff have examined the Welsh Government’s acquisition and ownership of Cardiff Airport. We confirmed plans for our study with the Welsh Government in March 2014. We have examined the Welsh Government’s decision making and oversight of the Airport. Our work has considered events leading up to the negotiations about the purchase and the purchase itself, including the due diligence work undertaken and whether the decision to buy on the terms agreed was soundly based. We have also considered the setting up and operation of the Welsh Government’s holding company arrangements and the overall progress that the Airport is making against its business plan and the Welsh Government’s own objectives. Our work is limited to those matters within the remit of the Welsh Government and its holding company, including wider issues such as transport access. We have not examined the detailed day-to-day operations of the Airport itself[3]. Appendix 2 shows a timeline of significant events from 2005 to March 2015.

6 Appendix 1 provides more detail about our audit methods. We have drawn in part on some related work by the Welsh Government’s Internal Audit Services. We have also discussed our work with colleagues at Audit Scotland in the context of their recent review of the Scottish Government’s purchase of Glasgow Prestwick Airport for the sum of £1, although the circumstances of that purchase are somewhat different. Glasgow Prestwick Airport had been making substantial losses for several years and its owner had indicated that it would shut the airport unless the Scottish Government intervened.

7 In preparing this report, we have taken into account that the disclosure of certain information relating to the due diligence work commissioned by the Welsh Government could prejudice any future negotiations between the Welsh Government and parties interested in taking a stake in the Airport and any return to the public purse. While we have reviewed the annual business plans that the Airport has submitted to WGC Holdco for approval, and other documentation available to Holdco, we have also limited our commentary on matters relating to the commercial strategy and performance of the Airport. We have also taken into consideration that certain matters relating to how the Airport conducts its business is commercially very sensitive as it operates in an open and competitive market, and disclosure of such information could prejudice the Airport’s business.

3 The Airport has its own board, which is responsible for operating the Airport and has comprised of the Chair, five other non-executive directors and four senior executive directors. Membership of the board has been in a period of transition, including the recent appointment of Roger Lewis as Chairman to replace Lord David Rowe-Beddoe at the end of his term in November 2015. Lord Rowe-Beddoe was appointed as Chairman when the Welsh Government acquired the Airport. The Airport has its own external auditors and does not fall within the audit regime of the Auditor General.

8 This report sets out our findings and conclusions based on the evidence that we have reviewed. We invited comments on the report, or, where appropriate, relevant extracts of the draft report, from the Welsh Government, CIAL and other third parties. We received no comments from the previous owners, Abertis, on the relevant extracts of the draft report that we provided.

Overall findings and conclusions

In the years before acquisition, the Welsh Government became increasingly concerned about the Airport's decline, despite efforts to provide support and latterly to improve its working relationship with the Airport's owners

9 Following a period of steady growth, passenger numbers had fallen from over two million in 2007 to just over one million in 2012. The decline in passenger numbers had a significant adverse effect on the Airport's financial results. Reported underlying earnings declined from £8.8 million in 2007 to around £800,000 in 2012, while sales declined from £22.6 million to £14.9 million. The Welsh Government was concerned that the Airport's owners were not doing enough to overcome its market disadvantages and reverse its declining fortunes.

10 The importance of the Airport's wider contribution to the Welsh economy was recognised, with a specific policy focus on proposals to improve transport access. There was no overarching Welsh Government strategy to develop the Airport in conjunction with its private owners. Ministers had, however, wanted to support the Airport by offering a £5 million grant towards the cost of capital works to the terminal, but Abertis did not want to proceed with the investment in the short-term and, in June 2011, the Welsh Government withdrew its offer. The Welsh Government also provided practical support for the Airport in the form of a four-year route development fund from 2006 to 2010. However, CIAL had expressed concern that the introduction of the fund occurred after a change in state aid rules that restricted the scope for it to offer adequate incentives to attract services. Overall, only £336,000 of the £4 million budget for the route development fund was spent.

11 The Welsh Government agreed with Abertis in April 2012 to establish a taskforce to involve key stakeholders in discussions about the Airport's development. The taskforce met three times and improved working relationships and mutual understanding between the Airport and key stakeholders. It also contributed ideas to the design of promotional material at the Airport[4] and prompted the secondment to the Airport of a Welsh Government official in October 2012 to develop a stronger working relationship between the two organisations. The Welsh Government disbanded the taskforce in October 2013, with the support of its members, after deciding to progress specific initiatives through other working groups, such as the Enterprise Zone and tourism sector panel.

4 In November 2011, as part of its efforts to promote Wales to a wide range of audiences, the Welsh Government entered into a commercial advertising and sponsorship agreement with CIAL. The contract cost the Welsh Government a total of £4.3 million (excluding VAT) over three years to November 2014. The contract was renewed to run for a further 16 months at a reduced rate of £1.24 million (excluding VAT).

The Welsh Government had a clear rationale for purchasing the Airport and undertook appropriate due diligence, with the price paid informed by a range of commercial and public asset valuations, but there were some weaknesses in the preparation of the business case[5]

12 The Welsh Government's rationale for buying the Airport was that it was failing under its previous ownership and that public sector ownership would give the Airport the stability and commitment that it needed to develop over the longer term.

13 The Welsh Government broadly followed the 'Five Case Business Model' (Appendix 3) with some adaptations due to time constraints. The full business case for the acquisition was only finalised once the purchase had been completed and a few sections were in fact incomplete. While we recognise that time constraints were a factor, we have identified a number of areas where we consider that the preparation of the business case could have been strengthened, including:

a reflecting more clearly in the stated investment objectives the public policy and economic development drivers behind the acquisition;

b articulating more fully the Welsh Government's assessment of other options – including but not limited to the do nothing option and the prospect of a joint venture with Abertis or a third party – despite acquisition being the Welsh Government's preferred option from the outset because of the constraints of the other options;

c strategic risks were identified, although further sensitivity analysis would have helped to highlight the possible impact of certain risks such as the impact on the value of the investment and the scale of external finance needed if things did not go as planned (the business case did, however, model four scenarios based on different marketing approaches); and

d a formal benefits realisation strategy would have helped to focus greater attention on arrangements for achieving wider social, economic and environmental benefits post-acquisition.

14 Drawing on professional advice, the Welsh Government negotiated a purchase price that was informed by the estimated value of the Airport as a public asset and a range of commercial valuations. The Welsh Government also took into account the wider strategic context. The estimated public asset value amounted to £472 million[6]. The related benefit-cost ratio of 8.6 based on the acquisition cost of £55 million compared well with commonly accepted standards for transport projects which indicate that ratios should typically fall somewhere in the range of five to 10.

5 In practice, the Welsh Government's preparation of the business case for purchasing the Airport, due diligence and the valuation of the Airport overlapped to a great extent, with the due diligence and valuation work informing the final negotiations.
6 The public asset valuation applied different assumptions to the commercial valuations, in line with Treasury guidance, and factored in the value of transport user and environmental benefits.

15 Commercial valuations can vary greatly depending on the assumptions applied, as was the case for the acquisition of the Airport. Ultimately the Welsh Government accepted a commercial valuation based on specific assumptions about the overall commercial performance of the Airport – centred on a positive assessment of business growth – and the cost of capital[7]. The Welsh Government has stated to us that it recognised that it did not have the same negotiating strength as a hypothetical investor looking to acquire any airport for purely commercial reasons. However, in our view, this situation reinforced the need for a more clearly articulated negotiating strategy.

16 Following a meeting between the First Minister and Abertis in July 2011, Welsh Government officials made informal enquiries to see if Abertis was open to offers to sell the Airport. Welsh Government documents note that, at that time, Abertis indicated that it was not interested in disposing of its assets but would accept £200 million. Officials felt that the price suggested was so unrealistically high as to be a total rebuttal of the Welsh Government's approach.

17 After Abertis approached the Welsh Government in September 2012 expressing a willingness to sell the Airport, the Welsh Government indicated that it would be willing to consider making a formal offer. In October 2012, the Welsh Government suggested a valuation of £35 million based on a preliminary assessment using credit agency reports (and subject to due diligence). Following further discussions, the Welsh Government and Abertis agreed in December 2012 to move into formal negotiations and due diligence on the basis of a non-binding offer of up to £55 million. An initial commercial valuation report that the Welsh Government had already commissioned at this point from KPMG suggested an indicative valuation range of between £25 million and £35 million but with a higher valuation possible by taking a positive view of future performance.

18 The Welsh Government received a series of interim commercial valuations in February and March 2013 from KPMG, the last of which suggested a valuation range of £20 million to £30 million. The Welsh Government considered that the updated valuation was too conservative, taking the view that that a 12 per cent cost of capital was reasonable while maintaining a market economy operator principle. The updated valuation had also excluded income from the Welsh Government's marketing contract with CIAL. Officials considered that this income could be maintained or replaced by other advertisers. The income generated from the contract was higher than previously achieved by the Airport and the value of the contract has since been reduced. The Welsh Government submitted a formal offer of £41 million to Abertis in early March 2013. Abertis rejected the offer and claimed that the Welsh Government's valuation took an unduly pessimistic view of business risk and growth potential.

7 The cost of capital is, in effect, the return on investment required by an investor (for a loan, it is the interest rate charged). The higher the cost of capital, the lower the price that an investor is willing to pay for the asset.

19 Following receipt of KPMG's last interim valuation report, the Welsh Government instructed KPMG to prepare an advice note which modelled a range of scenarios and included the marketing income from the Welsh Government that had been excluded previously. The resulting valuations varied greatly depending on the cost of capital applied to the calculations. Based on specific assumptions about future commercial performance and the cost of capital, and after taking further professional advice on the commercial and public asset valuation from Arup, the Welsh Government concluded that a valuation of around £55 million would be reasonable from a commercial perspective and acceptable to Abertis. Officials considered that the public asset valuation of £472 million also justified the price paid on public value for money grounds. The Welsh Government proceeded to negotiate a final purchase price of £52 million, along with £3.3 million in working capital (paragraph 4).

20 The Welsh Government sought a range of appropriate professional advice and undertook a rigorous due diligence process. The costs associated with the range of professional advice procured (Appendix 4), including work on the valuations, amounted to £1.04 million which is similar to the £1.08 million paid by the Scottish Government for due diligence for its purchase of Glasgow Prestwick Airport in November 2013. Due diligence identified some significant risks, but the Welsh Government took appropriate measures to mitigate risks where possible through the sale and purchase agreement.

The Welsh Government has established sound governance arrangements to manage its investment and the Airport is now likely to grow significantly, although progress is slower, and the need for external finance greater, than forecast at the time of acquisition

21 Officials followed legal advice in establishing a holding company to manage the investment at arm's length from the Welsh Government. A Management Agreement sets out the framework within which CIAL and its board shall operate, including reporting responsibilities, limits of delegation and governance. The holding company – WGC Holdco – has an appropriate level of control over the operating company, although the holding company might benefit from an external member from outside of the Welsh Government. There is also scope to improve aspects of performance monitoring, as we have reflected in our recommendations.

22 The Airport has a growth-oriented business plan aimed at delivering the Welsh Government's expectations for the Airport, although investment plans have been scaled back since acquisition. As part of the professional advice procured during the acquisition process, the Welsh Government commissioned an initial business plan for the Airport. That plan assumed a substantial increase in annual passenger numbers from one million in 2012 to 2.2 million in 2020, followed by more modest but steady growth to 3.3 million in 2037. The main themes in each of CIAL's own post-acquisition business plans have been consistent with the acquisition business plan. However, the 2013 plan included more ambitious targets for passenger growth based, in part, on attracting a low-cost carrier at an earlier stage and

investing more heavily in capital works to improve facilities, but on the assumption that commercial loan finance from the Welsh Government would be required. While the holding company approved the plan, it emphasised that it had misgivings about the strategy and that the decision on loan finance would be made elsewhere in the Welsh Government and would require a separate business case.

23 Many commercial airport operations carry significant debt to help finance their activities and realise business development objectives. The acquisition business plan indicated that £2.7 million of external finance would be needed before the Airport became cash-positive. The external finance requirement estimated by CIAL now stands substantially higher, having increased in each subsequent business plan. In October 2015, the Welsh Government tendered for an external independent review of the Airport's financial health and likely future finance requirements, with a final report expected by spring 2016.

24 The Welsh Government has approved since acquisition commercial loan facilities to the value of £23 million to help CIAL achieve its plans for growth – an initial loan facility of £10 million approved in November 2013 and a further loan facility of £13 million approved in principle in November 2014 (Figure 1). At 30 November 2015, all of the initial loan had been drawn down. The Welsh Government has recently consolidated both loan facilities under a single agreement. Audit Scotland's report on the acquisition of Glasgow Prestwick Airport by the Scottish Government in November 2013 noted that the Scottish Government had budgeted to make loans of £25.2 million by 31 March 2016.

25 Under UK Government accounting rules, any borrowing by CIAL counts against the Welsh Government's borrowing limits because CIAL is a subsidiary of the Welsh Government, even though CIAL is not itself a public authority. This is the case even if the loan is provided by a third party and not by the Welsh Government. The Welsh Government has therefore decided that it should provide any external finance directly in order to minimise financial risks, and alternative lenders such as banks were not considered.

Figure 1: Commercial loan finance committed and paid to Cardiff Airport as at 30 November 2015

Description	**Total committed (£000)**	**Total paid at 30 November 2015 (£000)**
Loan, principally for capital expenditure	10,000	10,000
Loan, principally for route development	13,000	0
Total loan finance	23,000	10,000

Source: Welsh Government

26 The approval of these loan facilities takes the total value of the Welsh Government's investment to date to £78 million in principle, which includes the £52 million purchase price and £3.3 million working capital invested as equity. However, the loan capital is repayable at commercial interest rates, so will ultimately yield a revenue stream to the Welsh Government and reduce capital investment back to £55.3 million. This investment also needs to be seen in the context of CIAL's plans for growth and the potential for capital appreciation. As part of the review of the Airport's financial position, the Welsh Government is also validating the terms of the loan agreement. The interest rate applied to the loan is based on standard benchmarks set by the European Commission, taking into account an assessment of CIAL's credit rating and the amount of collateral available to support the loan.

27 The Welsh Government has emphasised to us that it deals with loan applications from CIAL consistently with other business loan applications. There is no standard application process through which such loans are provided, with each case considered on its merits and subject to the availability of funds and due diligence. The value of CIAL's loan facility is high relative to others that have been provided by the Welsh Government to commercial organisations. However, the Welsh Government has indicated to us that there are a number of loans that are being considered or have been previously offered which are well above this figure.

28 CIAL's 2015 business plan indicates that additional finance will be needed through to March 2020. The Welsh Government is working on the assumption that it will hold its investment for the long-term, although it remains open to proposals for investment and joint working. However, any such interest has not, as yet, resulted in any formal negotiations.

29 Passenger numbers have fluctuated since acquisition but are likely to grow substantially now that Flybe has signed a 10-year agreement to base two aircraft at the Airport and become the Airport's main low-cost carrier. As is usual with such commercial agreements, there is a degree of financial risk for CIAL in the event that sales fall below the projected level, but the view of CIAL and Holdco is that the agreement is based on conservative assumptions and that robust measures are in place to mitigate foreseeable risks. CIAL expects that the arrival of Flybe will boost confidence in the Airport among other airlines.

30 Despite the agreement with Flybe, progress against the overall business plan will be slower than forecast at the time of acquisition. The passenger growth forecast in the acquisition business plan, which had informed the valuation of the Airport would have seen the Airport achieve around two million passengers in 2017-18. CIAL's current (2015) business plan forecasts around 1.4 million passengers in 2017-18.

31 The Airport will also fall short of the Welsh Government's medium-term profit expectations at acquisition. The acquisition business plan assumed net income (after incentives for airlines) of £95 million and underlying earnings of £21 million in the five-year period following acquisition. Subsequent plans from CIAL have progressively reduced these forecasts. This position reflects the reduction in

forecast passenger numbers, the cost of route development incentives, lower-than-anticipated marketing income from the Welsh Government and lower-than-anticipated savings from joint working with St Athan. The Airport has maintained a strong focus on cost control, has introduced new routes, has taken significant steps to improve customer service and the overall facilities and business-critical infrastructure, and has increased commercial income per passenger. However, turning the Airport around is proving more challenging than the Welsh Government expected at acquisition. The Airport is operating in a highly competitive environment and coming from an inherited low base.

32 There is no formal plan to realise wider benefits from the acquisition of the Airport, but the Airport is working more closely with relevant public sector stakeholders than before acquisition, building on the work of the taskforce that had been established prior to acquisition. We found that members of the Airport Consultative Committee – which brings together Airport managers with community and business representatives – welcomed the acquisition of the Airport by the Welsh Government.

33 In June 2013, the Welsh Government announced the introduction of an express bus service between Cardiff city centre and the Airport – a service that had been proposed in its 2010 National Transport Plan. The service is subsidised by the Welsh Government at a cost of around £500,000 a year, but is contracted by the Vale of Glamorgan Council. The Welsh Government has emphasised to us that the subsidy for the bus service secures provision of transport services for the public where the market would fail to do so, and is not intended to support the Airport; indeed a successful service might reduce its car parking income. The Welsh Government commissioned a review of the service in January 2014. Following the review, the Welsh Government (through the Vale of Glamorgan Council) awarded a new contract with a lower service frequency but with the existing fares and routes retained and specialist market research commissioned. Passenger numbers in 2014-15 were markedly higher than in 2013-14 which has reduced the per passenger.

34 There remains a shuttle bus service between Rhoose Cardiff International Airport railway station and the Airport, which is also supported by a public subsidy of £135,000, with the current agreement running to mid-2016. The Welsh Government's National Transport Finance Plan (July 2015) states that a more frequent rail service will be introduced on the Vale of Glamorgan Line (which links Cardiff and Bridgend to Rhoose, south of the Airport) but there is no commitment to a specific date at present.

35 Prior to acquisition, the Welsh Government had already established a marketing group to improve the coordination of marketing activity and develop opportunities for inbound tourism. That group continued to meet until February 2014 and enabled joint working between the Welsh Government and the Airport on a range of matters. However, the scope for joint marketing campaigns was limited by the different priorities of Visit Wales and the Airport.

36 The acquisition business plan prepared for the Welsh Government envisaged that the Airport would make significant savings by providing joint airfield management services for the St Athan airfield when it comes under full civilian control. The Airport's first business plan in 2013 included estimated savings of £500,000 a year from 2015-16, rising to £1.0 million in 2016-17 and £1.5 million a year thereafter. While the Welsh Government has established with the Airport a task group to plan and deliver the savings, it is now unlikely that significant savings can be made until 2017-18 at the earliest. CIAL has, however, increased its income from St Athan's use of air traffic services provided by CIAL following a contract renewal.

37 The Airport has taken measures to improve its environmental performance. The key areas of focus relate to overall energy efficiency, waste management, wind farm mitigation measures, and solar energy. The Airport won the Airport Operators' Association award for 'best environmental initiative' in 2015 for its measures to reduce waste and cut CO_2 emissions through more efficient energy use and aircraft landing practices. The Welsh Government also conducted an equality impact assessment of the Airport in 2014. The Airport has agreed an equality action plan with the Welsh Government to implement appropriate measures to deal with the issues identified. Most of the measures are relatively straightforward and low cost but some will require capital expenditure and take longer to introduce. The Airport has also taken certain steps in this regard in addition to the issues raised in the equality report.

Recommendations

38 We have commented in this report on various matters relating to the acquisition process. While there will be general lessons to learn from that process, our recommendations below focus on issues that relate specifically to the ongoing relationship between WGC Holdco and CIAL or wider matters that are relevant to the wider relationship between the Welsh Government and the Airport, for example with regard to transport access.

39 We recognise that, in taking forward any action in response to these recommendations, the Welsh Government and Holdco will need to consider carefully the arm's length basis on which CIAL operates and any possible constraints in a state aid context.

R1	The Holdco board comprises three senior civil servants in one department of the Welsh Government. We agree with a recommendation made previously by the Welsh Government's Internal Audit Services that the board would benefit from an independent, external perspective. We recommend that the Welsh Government appoints to the Holdco board of directors someone from outside the Welsh Government with appropriate business experience. (Paragraph 3.7)
R2	In establishing the holding company, Welsh Government officials had proposed that the Chairman of CIAL would be invited to sit as a non-executive director of Holdco in line with normal company / commercial practice, but this has not happened and is not reflected in the Management Agreement between Holdco and CIAL. We recommend that Holdco considers amending the Management Agreement to reflect its preferred policy on the role of the Chairman of CIAL on the Holdco board. (Paragraph 3.6)
R3	As a private company operating at arm's length from the Welsh Government, the board of CIAL can appoint its own successors as non-executive directors. However, Holdco has the right to veto appointments and to make its own appointments if deemed necessary. We recommend that Holdco consult with the board of CIAL with a view to agreeing the principles for appointing non-executive directors to the CIAL board. (Paragraphs 3.8 to 3.11)

R4	Holdco began to develop a set of key performance indicators for CIAL in 2013 but never completed the process. The CIAL board focuses on financial performance but the Welsh Government has wider objectives for the Airport that need to be considered, such as employment, tourism, environmental impact and equality. Neither Holdco nor CIAL publish an annual report (other than the statutory annual report and accounts for Companies House) which outlines its progress against objectives. We recommend that Holdco: • Develop and agree with CIAL a set of performance indicators that covers the main aspects of the Airport's contribution to the Welsh Government's objectives. These should include essential commercial drivers such as passenger growth, earnings and customer services measures, but also broader economic, social and environmental matters that capture the wider contribution of the Airport and in keeping with the principles of sustainable development. • Encourage CIAL to publish an annual report summarising the progress of the Airport and covering the areas outlined above. (Paragraphs 3.13 to 3.19)
R5	Holdco asked CIAL to submit business plans with a two year planning period with effect from 2015, whereas CIAL had included five-year financial projections with its previous business plans and its draft 2015 plan. Holdco considers that a two-year horizon offers greater certainty on which to base decisions as longer-term projections can be inaccurate and misleading. While we recognise that Holdco might not wish to formally approve plans beyond the two-year period, we recommend that Holdco adopt a longer planning horizon for CIAL and return to its previous practice of considering at least five-year financial projections as part of its review of the Airport's annual business plan. (Paragraph 3.23)
R6	The First Minister stated that the acquisition of Cardiff Airport would enable the Welsh Government 'to develop a more coherent approach to our national infrastructure and to integrate the Airport into our wider economic development strategy'. Currently there is no overall plan or strategy to achieve practical benefits. CIAL last published a Master Plan for Cardiff Airport in 2006, but Holdco agreed to defer its requirements for a revised plan until the Commission on Airport Expansion chaired by Howard Davies had reported with its recommendations for the London airports. Now that review is complete, we recommend that the Welsh Government and CIAL jointly prepare a revised Master Plan with an integrated, long-term strategy for developing the Airport to meet both commercial and wider policy objectives.

R7 The Welsh Government has subsidised the shuttle bus service between the Airport and Rhoose Railway Station since 2005 and a new express bus service between central Cardiff and the Airport since 2013. The express bus service is growing and subsidy per passenger is declining, and a recent evaluation concluded that it should continue. The subsidy for the less-popular shuttle bus is stable but accounts for a high proportion of the total cost of the service and has never been evaluated. It is not clear that both services are needed to ensure that the Airport is well connected to the public transport network. We recommend that the Welsh Government evaluates the shuttle bus service before the contract expires in terms of its contribution to wider policy objectives and also value for money against other options for travelling to the Airport.
(Paragraphs 3.54 to 3.59)

Part 1

In the years before acquisition, the Welsh Government became increasingly concerned about the Airport's decline, despite efforts to provide support and latterly to improve its working relationship with the Airport's owners

1.1 This part of the report summarises some of the longer-term background to the purchase of Cardiff Airport by the Welsh Government in 2013 and the Welsh Government's relationship with the previous owners. This commentary is based on a review of the diligence reports commissioned by the Welsh Government as part of the acquisition process, other Welsh Government records and policy documents – including key documents relating to the European Commission's approval of a potential grant to improve infrastructure at the Airport, and published information about the performance of the Airport.

1.2 We have also drawn on feedback from stakeholders including Welsh Government officials and senior managers at the Airport.

Following a period of steady growth, the performance of the Airport declined sharply from 2007 onwards

1.3 We understand that Cardiff Airport had a constructive relationship with the Welsh Government until about 2007 and worked with officials on a range of matters, including promotion of Wales as a tourist destination. Annual passenger numbers increased from 1.1 million to 2.1 million between 1997 and 2007. The Welsh Government also made some improvements to transport links, in particular the re-opening of the Vale of Glamorgan railway line for passenger services. A new railway station was opened at Rhoose (about a mile from the airport terminal by road) to serve both the village of Rhoose and the Airport itself, which was connected by a shuttle bus to the station.

1.4 The Welsh Government had introduced a system of relationship managers to manage its relationship with around 30 key companies across Wales that were considered to be particularly important for their contribution to employment and the local and regional economy. However, Cardiff Airport was not treated as an anchor company and did not have its own relationship manager to act as a single point of contact with Welsh Government departments.

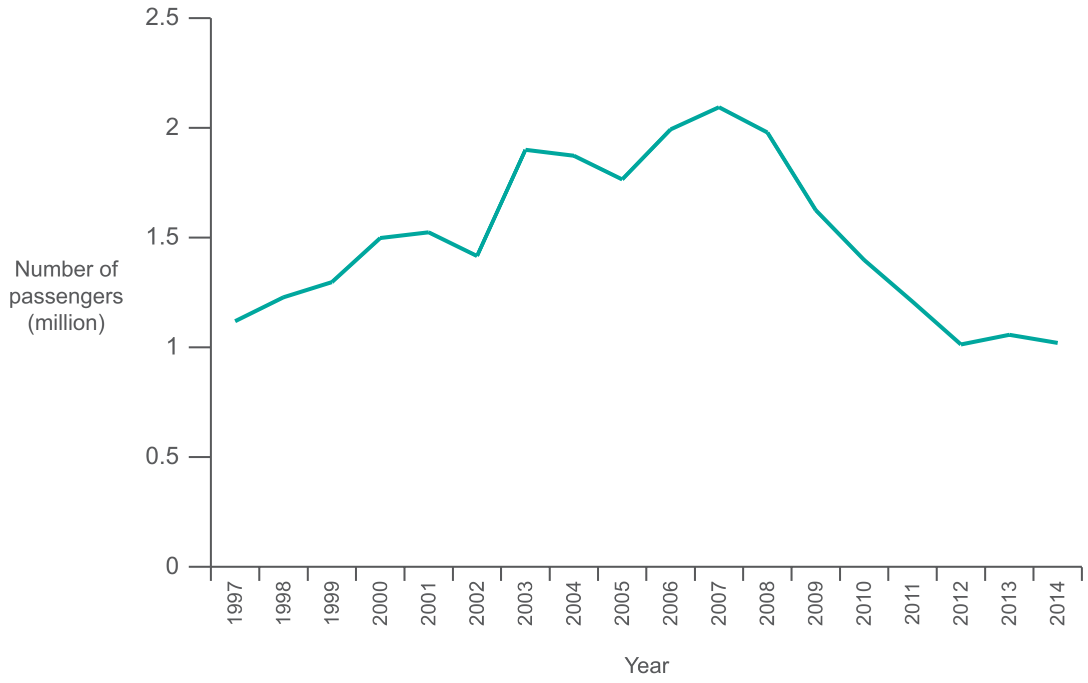
1.5 The TBI Group was acquired by the Spanish infrastructure group Abertis Infraestructuras SA (Abertis) in 2005. As a result of this acquisition, Abertis became the new owner of Cardiff Airport as well as two other UK airports owned by TBI (Luton and Belfast International). The then Managing Director, Jon Horne, remained in post but left CIAL in 2007. In the years that followed, we understand that there was less contact at a senior level and less joint working on tourism promotion. Welsh Government officials have attributed this decline in engagement to a change in emphasis within CIAL towards retrenchment and cost reduction in a more difficult economic climate. However, CIAL told a Parliamentary inquiry in 2008[8] that it would have welcomed more marketing activity by the Welsh Government.

8 Welsh Affairs Committee of the House of Commons, inquiry into cross-border provision of public services, minutes of evidence session on transport services, 9 December 2008

1.6 Passenger numbers continued to grow after Abertis acquired the Airport, from 1.8 million in 2005 to a peak of 2.1 million in 2007. However, numbers declined sharply in the years that followed, falling to 1.4 million in 2010 and 1.01 million in 2012 (Figure 2). This decline reflected the loss of several low-cost carriers that accounted for a significant proportion of the Airport's passenger numbers, especially BMIBaby which pulled out in 2011. The economic downturn also contributed to a general reduction in air traffic that affected most UK airports.

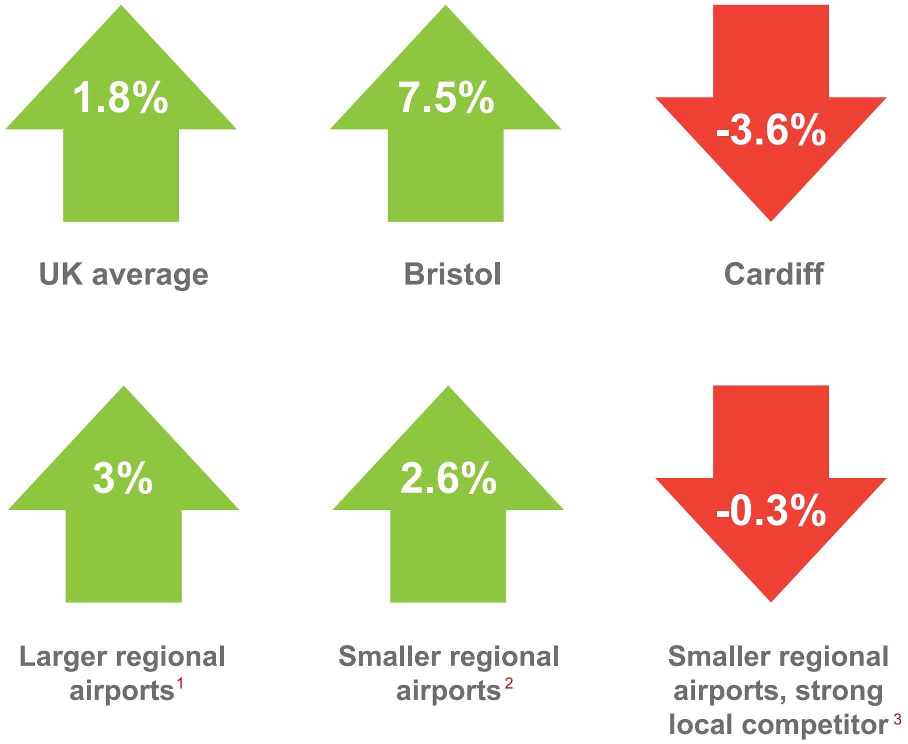
1.7 Nevertheless, the Welsh Government was concerned that Cardiff Airport was underperforming similar airports by a significant margin (Figure 3). Cardiff has a smaller catchment area than its main competitor, Bristol, and one that has a less affluent population that is less likely to travel by air. The growth of Bristol Airport, with its wide range of destinations and routes at competitive prices, has attracted many passengers from South Wales and by 2012 Cardiff Airport accounted for only 25 per cent of flights by residents within its catchment area. CIAL considers that Cardiff Airport's performance during the downturn, while poorer than other small regional airports, was similar to that of four other airports that face strong competitors within the same wider catchment area. These other airports – Glasgow Prestwick (facing Glasgow), Bournemouth (facing Southampton), Doncaster (facing East Midlands) and Durham Tees Valley (facing Newcastle) – do, however, vary considerably in their financial resources and the size and affluence of their catchment areas.

Figure 2: Terminal passenger numbers at Cardiff Airport, 1997-2014



Source: Civil Aviation Authority

Figure 3: Compound annual growth rate in terminal passenger numbers, 2001-2012



Year	2001-2008	2008-2012
UK average	+3.8%	-1.6%
Bristol	+12.8%	-1.3%
Cardiff	+3.8%	-15.4%
Larger regional airports[1]	+6.4%	-2.5%
Smaller regional airports[2]	+8.2%	-6.5%
Smaller regional airports, strong local competitor[3]	+9.5%	-15.4%

Notes:

1 Larger regional airports are those outside the London area with three million to 10 million passengers in 2008 (it excludes Manchester which is an outlier with around 21 million passengers in 2008).

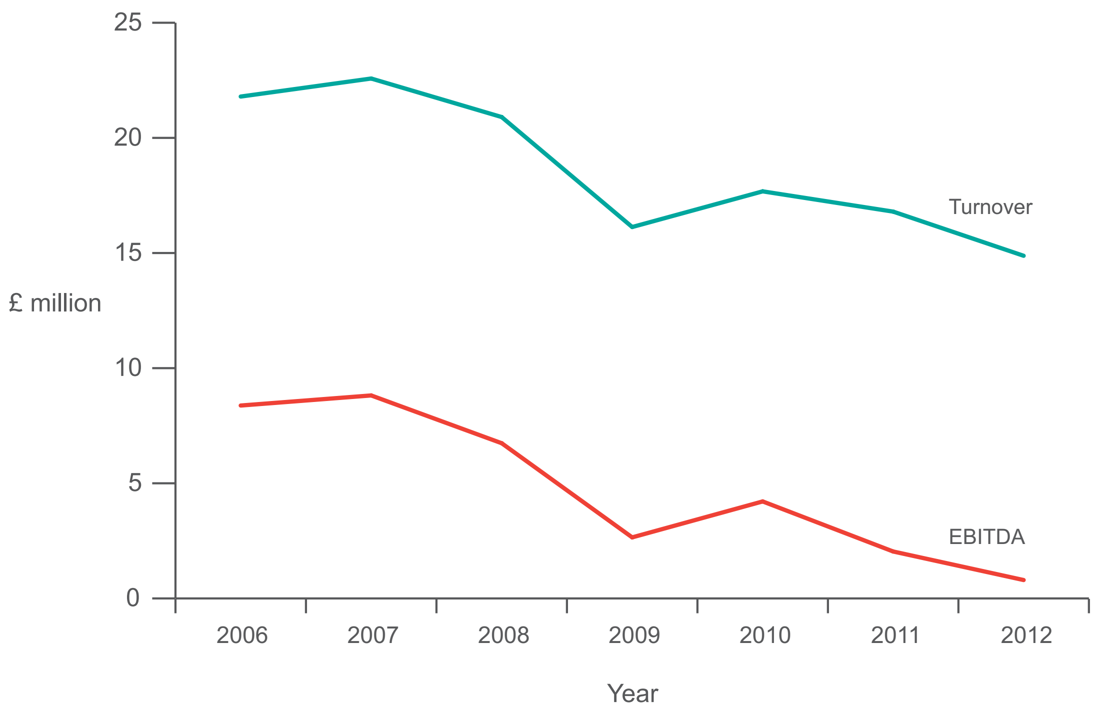
2 Smaller regional airports are those with 500,000 to three million passengers in 2008 (therefore including Cardiff).

3 Smaller regional airports with a strong local competitor (within the wider catchment area) are Glasgow Prestwick, Cardiff, Bournemouth, Doncaster and Durham Tees Valley.

Source: Wales Audit Office analysis of Civil Aviation Authority data

1.8 The decline in passenger numbers had a significant adverse effect on the Airport's financial results. There was a corresponding decline in aeronautical income (fees paid by airlines mainly based on the number of departing passengers) and commercial income (for example, from car parking or retail concessions) which depend on the volume of passengers. A large proportion of an airport's running costs are fixed, however, and this meant that profit margins were squeezed. CIAL's reported underlying earnings declined from £8.8 million in 2007 to around £800,000 in 2012, while sales declined from £22.6 million to £14.9 million (Figure 4).

Figure 4: Turnover and underlying profits of CIAL, 2006-2012



Note: EBITDA reflects earnings before interest, taxation, depreciation and amortisation (underlying profits).

Source: CIAL's statutory accounts

1.9 The Airport's owners responded by requiring substantial cost reductions, but with the consequent risk that this could reduce service levels and cause essential equipment to wear out more quickly. The Welsh Government was concerned that the Airport's owners were not doing enough to overcome its market disadvantages and reverse its declining fortunes, with little investment in infrastructure or new routes and a strong emphasis on cost-cutting that in its view was unlikely to turn the Airport around. The First Minister criticised the Airport for its service levels and stated that potential investors and business groups had commented negatively on the Airport's appearance and service. The Welsh Government was concerned about the overall impact on the Welsh economy and Wales' international business reputation.

The importance of the Airport's wider contribution to the Welsh economy was recognised, with a specific policy focus on proposals to improve transport access

1.10 While the Airport was clearly an important part of the country's economy and transport infrastructure in the years before acquisition, it did not feature explicitly in certain high-level policies such as the Economic Renewal Programme or the Programme for Government and there was no overarching strategy to develop the Airport in conjunction with its private owners. There were, however, references to the importance of the Airport to the economy in the Wales Spatial Plan update (2008) and the Wales Infrastructure Investment Plan (2012), with both documents commenting briefly on access to the Airport by road and public transport.

1.11 The Welsh Transport Strategy (2008) had included a commitment to develop a surface access strategy to improve access to Cardiff Airport and St Athan, with the first preference being to improve rail and bus. The National Transport Plan (2010) included an aspiration to 'enhance international connectivity from Cardiff Airport' but did not include specific actions, outcomes or targets in this regard – a fact noted by CIAL in its evidence to the National Assembly's Enterprise and Business Committee in 2012.[9] The plan did, however, refer to specific projects relating to the Airport:

a Increased frequency of services on the Vale of Glamorgan Line, which would include trains to Rhoose/Cardiff International Airport station.

b Introduction of a high-quality express bus service from Cardiff city centre to the airport.

c Safety improvements to the A4226 between the Airport and the M4, known as Five Mile Lane. The Welsh Government did consider building a new link road from the M4 to the Airport and three options were developed in 2008, with estimates of the cost ranging from £80 million to £135 million. However, the scheme was not assessed as being of sufficiently high priority, given the cost involved, to feature in the 2010 National Transport Plan and is unlikely to proceed in the foreseeable future.

9 **Cardiff Airport evidence to the Enterprise and Business Committee's inquiry into the future of Welsh ports and airports**, 2012, page 6.

1.12 None of these actions were completed before the Airport was acquired, but the express bus service was introduced in 2013 shortly after the acquisition with a £500,000 a year subsidy from the Welsh Government. The National Transport Finance Plan (July 2015) states that additional services on the Vale of Glamorgan Line will be introduced after a major re-signalling project is completed in 2016 and improvements to the A4226 (Five Mile Lane) are currently being funded.

1.13 In December 2013, the Welsh Government issued an interim paper on aviation in Wales[10], which provided an overarching framework for more detailed action plans to benefit from growth opportunities in the aerospace and aviation industries. The paper outlined a number of actions that the Welsh Government would take to promote aviation, including:

a continuing to press the case for devolution of Air Passenger Duty, which would allow the Welsh Government to cut rates in order to stimulate increasing passenger numbers;

b continuing to ‘explore and implement compliant mechanisms to help attract new services to Cardiff Airport’ although state aid rules currently significantly limit the scope for funding new routes directly;

c promoting Cardiff as the site of additional airport capacity to relieve pressures in South East England and avoid the need to add runways to the existing London airports;

d maintaining an express bus service between Cardiff city centre and the Airport and doubling the frequency of rail services on the Vale of Glamorgan Line; and

e commissioning technical studies to help develop highway proposals to improve road links to the Cardiff Airport and St Athan Enterprise Zone.

10 Welsh Government, **Interim Paper on Aviation**, December 2013

Ministers had offered a grant towards the cost of capital works to the terminal, but Abertis did not want to proceed with the investment in the short-term and, in June 2011, the Welsh Government withdrew its offer

1.14 The Airport's continued growth between 2005 and 2007 led CIAL to develop plans for reconfiguring the terminal building and improving various facilities. Ministers agreed to consider the possibility of a grant to help pay for these improvements, and work to obtain the necessary state aid approval from the European Commission began in 2007. This process involved the Welsh Government and CIAL working together to develop costed plans and to make the case to justify public assistance in a highly competitive market. Progress was slow, and in 2009 the Welsh Government sought to re-energise the preparation of the state aid notification, which was finally submitted to the European Commission in October 2010.

1.15 The European Commission approved the state aid proposal in May 2011, which involved a potential Welsh Government capital grant of £5 million towards capital costs of £26.5 million, with the remaining £21.5 million being met by CIAL. The grant was to fund improvements to infrastructure, including:

a terminal enhancements to improve the flow of passengers at peak times;

b upgrade of support systems for the enhanced terminal;

c improvements to roads, lighting and car parks;

d airside operational enhancements (structural upgrades to taxiways and stands, airside lighting, equipment and systems); and

e upgrades to air traffic systems.

1.16 The state aid approval gave the Welsh Government the authority it needed to offer a grant to CIAL on the terms set out in the notification, which envisaged completion of all works by the end of 2014. The Welsh Government was keen to publicise the state aid approval and proceed to offer a grant to deliver the related investment as quickly as possible. While local managers were willing to proceed, it appeared that the Airport's owners were unable or unwilling to provide the necessary funding. It became clear to Welsh Government officials that CIAL could not accept a grant that required them to invest within the timeframe envisaged by Ministers, and the company sought assurances that it would only have to sign up to investment spread over a 15-year period.

1.17 In light of these developments, the Welsh Government decided to withdraw the in-principle offer of a grant to CIAL in June 2011. The First Minister met the Chief Executive of the Abertis Group in July 2011 to express the Welsh Government's concerns about the performance and image of the Airport and the absence of any commitment to invest on the scale required to obtain the grant. Both parties agreed to work together more closely and to involve other partners to support the Airport. However, Abertis did not believe there was a strong business case for it to invest substantially in the Airport in light of the economic downturn and falling passenger numbers. The owners felt that it made no sense to invest in infrastructure when the Airport had plenty of spare capacity and the priority was to expand the passenger base through incentives to attract new airlines and routes, for which Abertis wanted Welsh Government support.

1.18 The Welsh Government had operated a four-year route development fund from 2006 until 2010, which provided financial support for CIAL to grant incentives to airlines for establishing new routes. However, CIAL had expressed concern that the introduction of the fund occurred after a change in EU state aid rules (published in 2005 and coming into force in June 2007) that restricted the scope for it to offer adequate incentives to attract services to Cardiff. The devolved administrations in Scotland and Northern Ireland had introduced route development funds earlier and, in CIAL's view, had benefited to a greater extent from the more flexible state aid regime. The tighter regulations meant that support for services to Brussels and Manchester had to be withdrawn in June 2007 when the new regulations came into force. Nevertheless, the Welsh Government did support routes to Barcelona (until November 2007) and Paris (until April 2010) under the revised regime. Only the Paris service lasted for the full three-year period permitted by the state aid regulations; support for the other three routes ceased after relatively short periods. Overall, only £336,000 of the £4 million budget for the route development fund was spent.

The taskforce established by the Welsh Government in 2012 improved working relationships and mutual understanding between the Airport and key stakeholders, before being disbanded with the support of its members when the Welsh Government decided to progress specific initiatives through other working groups

1.19 The First Minister and Abertis agreed in April 2012 to establish a taskforce that would bring together major stakeholders in a bid to improve mutual understanding and help maximise the potential of the Airport through joint working (Box 1). We consulted members of the taskforce on its effectiveness, and the consensus of those who responded was that it succeeded in raising the profile of the Airport, enabling a good dialogue on the key issues facing it, and developing mutual understanding between the bodies represented on the group. Members also supported the decision to disband the taskforce in October 2013, on the basis that it had met its high-level objectives and specific initiatives were best taken forward in alternative working groups such as the Enterprise Zone or tourism sector panel. As a result, the impacts of the taskforce were mainly intangible, although it did contribute ideas to the design of promotional material at the Airport and prompted the secondment to CIAL of a Welsh Government official for an anticipated period of 16 months starting in October 2012.

1.20 The Welsh Government hoped that the secondment would improve relationships with the Airport, develop its corporate knowledge of the aviation industry and support the Airport by showing airlines and other key stakeholders that the Airport and the Welsh Government were cooperating. As part of the secondment, the secondee was responsible for helping to develop strategy, communications and public relations, and investment propositions for airlines. The secondee was recalled to the Welsh Government in December 2012 when due diligence for the purchase of the Airport began, to avoid a possible conflict of interest, but re-joined CIAL for a further two-year secondment starting in April 2013. In this second secondment he was also responsible for managing capital projects. Both secondments were fully paid by the Welsh Government. Both the Welsh Government and CIAL considered that the secondments have worked well and have succeeded in improving relationships and supporting the Airport.

1.21 In parallel with the taskforce (but not attributable to it), the Welsh Government established a marketing group in June 2012 to improve the coordination of marketing activity and develop opportunities for inbound tourism. The group continued to meet after acquisition and delivered various initiatives (paragraphs 3.60 and 3.61).

Box 1 – Cardiff Airport Taskforce

The group was chaired by the First Minister until July 2013, and then by the Minister for Economy, Science and Transport. The taskforce included representatives from Cardiff Airport (both CIAL and TBI as the holding company for Abertis), the Welsh Government, local authorities, St Athan and Cardiff Airport Enterprise Zone, tourism promotional groups, business groups and trade unions. The aims of the taskforce were:

- To engage partners in high-level dialogue on strategic air transport development issues.
- To promote better communication between Cardiff Airport, the business community, the Welsh public sector and other relevant bodies.
- To identify and recommend specific improvements and investment needed for Wales to boost air connectivity.
- To deliver a shared understanding of the operational and commercial factors which underpin development of the air transportation industry.
- To deliver joint strategic initiatives for Cardiff Airport aimed at:
  - growing Cardiff Airport (leisure, business and freight traffic);
  - improving the experience of airport users;
  - maximising its economic impact, commercially and for Wales; and
  - minimising negative environmental effects.

The taskforce met three times in 2012 and 2013 and held high-level discussions on issues facing the Airport and initiatives to promote its development including route development, marketing activity and re-branding of the Airport. The group also discussed wider issues such as the Airport's impact on business investment and the long-term potential for Cardiff to act as a 'western gateway' for the London airports to alleviate capacity constraints.

1.22 In November 2011, as part of its efforts to promote Wales to a wide range of audiences, the Welsh Government entered into a commercial advertising and sponsorship agreement with CIAL to convey key messages to leisure and tourism markets through on-site advertising at the Airport and sponsorship of the business lounge. Acting on a recommendation from the taskforce, officials developed a more comprehensive branding campaign that involved installing original works by Welsh artists, and the value of the contract was increased in November 2012 for the remaining two years of the contract.

1.23 The Welsh Government was satisfied that the contract offered value for money on the basis that it considered it was paying a genuinely commercial rate and the services purchased did not exceed what the Welsh Government needed for its own purposes. The contract cost a total of £4.3 million (excluding VAT) over three years to November 2014. The contract was renewed to run for a further 16 months at a reduced rate of £1.24 million (excluding VAT), with more artwork being developed for additional areas of the Airport. The impact of the contract had not been evaluated prior to the contract renewal – the Welsh Government had indicated that such an evaluation would take place in the final quarter of the original three-year contract. However, the Welsh Government has recently commissioned market research to assess passenger views about the installations. The research found that passengers' reactions to the installation were generally positive.

Part 2

The Welsh Government had a clear rationale for purchasing the Airport and undertook appropriate due diligence, with the price paid informed by a range of commercial and public asset valuations, but there were some weaknesses in the preparation of the business case

2.1 This part of the report covers the development of the Welsh Government's business case for purchasing the Airport, the due diligence for the purchase, the valuation of the Airport and negotiations with the Airport's owners. We have dealt with each of these aspects separately, but in reality they overlapped to a great extent as due diligence and valuation work occurred simultaneously and informed the final negotiations. The business case for purchasing the Airport was developed in stages and only finalised once the purchase had been completed. We have not sought to re-perform any of the due diligence or valuation work undertaken by the Welsh Government's professional advisors. Appendix 2 sets out the timeline of key events.

2.2 The Welsh Government has emphasised to us that consideration of public policy and general economic development were the primary drivers behind acquisition. Nevertheless, commercial considerations were relevant, as were compliance issues associated with the market economy operator principle. European state aid rules require that a public authority that buys a commercial business interest must be able to provide reasonable evidence that it has done so on a commercial basis, paying no more than a hypothetical private investor making a long-term investment. This is known as the market economy operator principle. The European Commission may order any excess value to be recovered from the beneficiary (the seller of the business) if it establishes that the state aid has given an unfair advantage to the beneficiary and so distorts or threatens to distort competition.

2.3 The due diligence work commissioned by the Welsh Government in advance of the final acquisition included an assessment of the strategic context for the acquisition, which summarised the risks and benefits of buying the Airport compared with the 'do nothing' option. The valuation work commissioned by the Welsh Government included an estimation of the value of the Airport as a public asset, alongside a range of commercial valuations. Welsh Government officials consider that informed decisions were taken with all the necessary evidence provided.

2.4 The Welsh Government generally followed Treasury guidance in the preparation of its business case for the acquisition, but time constraints required a flexible approach. We have identified a number of areas where we consider the process could have been strengthened.

The Welsh Government had a clear rationale for purchasing the Airport, but, in our view, did not set out clearly enough its investment objectives or its consideration of alternative options, risks and benefits

The Welsh Government broadly followed the Five Case Business Model with some adaptations due to time constraints

2.5 The Welsh Government is committed to following the Five Case Business Model, a method of developing a robust business case that incorporates HM Treasury's guidance for central government bodies, **The Green Book: Appraisal and Evaluation in Central Government**, last updated in 2011. The Five Case Business Model is based around five distinct elements – the strategic, economic, commercial, financial and management cases – to ensure that all relevant aspects of an investment decision are properly considered. Appendix 3 outlines the purpose of each case and the process for developing a complete business case, which includes:

- a **a strategic outline case** initially, to make the case for change, set investment objectives and identify options for delivering the project;
- b **an outline business case**, to shortlist and evaluate options and plan the project in detail based on the chosen option; and
- c **a full business case**, to finalise the procurement route (if applicable) and management arrangements and revisit earlier stages.

2.6 The Treasury's guidance allows the model to be used flexibly to suit a particular project. For the acquisition of Cardiff Airport, time constraints required a flexible approach. For example:

- a The Welsh Government did not produce an outline business case to avoid delays during the fast-paced acquisition process. Officials prepared a strategic outline case in September 2012, before negotiations began, and incorporated the outline business case into the full business case, which was developed during the due diligence process but only finalised in April 2013 after the purchase itself had been completed. A few sections of the final business case were in fact incomplete, with brief notes or headings that needed further explanation.[11]
- b The Welsh Government's Permanent Secretary undertook a review of the progress with and evidence available to support the acquisition in February 2013, before officials entered final negotiations with Abertis. The Welsh Government believed that formal gateway reviews – to assess independently the readiness of the acquisition project to proceed to the next stage – were impractical because timescales were too tight and options too limited, and because much of the necessary information would not be available until the end of the process because of the nature of the transaction.

11 For example, part of the section on 'scope of project and service requirements' stated: 'Use Newcastle/Jersey examples regarding diversification' but no detail was provided as to how these examples would have benefited Cardiff Airport.

c Officials did not feel it was practical to consult widely in preparing the business case, given the tight timescales involved and the need for strict confidentiality during negotiations and due diligence, under the terms of a non-disclosure agreement with Abertis. Information was restricted to a small number of officials, with regular meetings during the due diligence and negotiation process including the involvement of the Permanent Secretary and other senior officials.

The Welsh Government had a clear rationale for buying the Airport, although the investment objectives listed in the business case did not reflect fully the public policy and economic development drivers behind the acquisition

2.7 The Welsh Government's rationale for buying the Airport was that it was failing under its previous ownership and that public sector ownership would give the Airport the stability and commitment that it needed in order to develop over the longer term. Our review of the Welsh Government's business cases and interviews with officials indicated that the following specific factors influenced the decision to buy the Airport rather than to adopt another form of intervention:

a A concern that the perceived underperformance of the Airport was hindering efforts to attract inward investment and encourage tourism.

b A concern that the Airport might close altogether if passenger numbers continued to decline, especially if a major airline decided to leave.

c The fact that closure would lead to the loss of around 1,600 jobs at the Airport site, many of them well paid and highly skilled.

d The future of the British Airways Maintenance Cardiff facility would be at risk unless it could share the costs of the airfield with the Airport.

e Abertis had responded to the declining fortunes of the Airport by cutting costs rather than investing in infrastructure and attracting new routes, and this was making the Airport less attractive for airlines, passengers and businesses. The Welsh Government felt that Abertis was unwilling to invest and a new owner was needed to turn the Airport around.

f If Abertis sold CIAL to another private buyer, there was a risk that it would once again become a low priority for investment in a large portfolio of infrastructure assets held by a major company, and the Airport would fail to make the necessary progress.

2.8 The Five Case Business Model emphasises the importance of setting clear outcome-based investment objectives at the outset of a project. These define the purpose of the investment and should form the basis for evaluating options.

2.9 The strategic outline case set an overarching aim of positioning the Airport as 'a strong regional operator with a long-term stable position and robust trading performance'. Several overarching objectives were subsequently stated, with varying degrees of emphasis on commercial and wider economic factors, although all were broadly consistent with the rationale stated above (Box 2).

Box 2 – Welsh Government objectives for buying the Airport, as presented in various documents leading up to the acquisition

> Our overarching aim is to position the Airport as a strong regional operator with a long term stable position and robust trading performance.
>
> Strategic Outline Programme – in effect the preliminary business case for acquisition of the Airport, September 2012

> (Wales needs)…a dynamic, international gateway airport with strong international connectivity and a welcoming open door for tourism. Public ownership would enable us to develop a more coherent approach to our national infrastructure and to integrate the Airport into our wider economic development strategy.
>
> First Minister's written statement, 18 December 2012, in which he announced Welsh Government's intention to proceed with an acquisition subject to due diligence

> The Welsh Government's overriding objective is to secure the future of the Airport and the businesses and employment it supports, such as British Airways Maintenance Cardiff.
>
> Full Business Case, April 2013 but developed before the purchase was completed

> To be acknowledged as the airport of choice for Wales and its gateway to the world.
>
> Acquisition business plan, March 2013

2.10 The full business case had the following investment objectives:

a To secure CIAL at the lowest possible expense to the public purse that also:

- represents an evidence-based, independently verified, commercial market economy rate; and
- provides sufficient ability at point of acquisition for us to inject the necessary funding, on a commercial basis, to realise the agreed commercial strategy.

b To evidentially provide qualified assurances that the investment will deliver a return to the public purse over a 25 to 40-year investment period.

2.11 While the objectives in the full business case – which relate solely to the option selected – are long term and clearly measurable, they were financially focussed. They did not include any reference to the Airport's contribution to the wider economy, especially the potential for promoting investment and inbound tourism, nor the potential environmental benefits. Given the Welsh Government's commitment to sustainable development, the emphasis it has placed on the public policy and general economic development context to the acquisition (paragraph 2.2), and the fact that it had commissioned a high-level assessment of the possible impact of acquisition from a sustainable development perspective (Appendix 4), we consider these matters should have been reflected more clearly in the investment objectives.

The Welsh Government gave some consideration to other options, but acquisition was the preferred option from the outset because of the constraints of the other options

2.12 It is good practice to assess a wide range of options for delivering the investment objectives. Treasury guidance recommends that this be done in the strategic outline case so that the advantages and disadvantages of all feasible options are considered at an early stage. The strongest options should be shortlisted at the next stage (outline business case) and appraised in detail against each of the investment objectives before the preferred option is finally selected.

2.13 The Welsh Government identified several options before it entered negotiations with Abertis and included these in the initial strategic outline case, of which three were later shortlisted, as referenced in the full business case (Figure 5). The Welsh Government did not prepare an outline business case (paragraph 2.5a).

2.14 The Welsh Government's strategic outline case stated that outright purchase was the preferred option. We have seen no written evidence that other options were discussed with Abertis, other than a brief reference in the first offer letter to Abertis in October 2012. That letter stated that the Welsh Government would consider a joint venture with Abertis if an outright purchase could not be completed, but pressures on long-term budgets would be a 'significant impediment' to a joint venture. We understand that the Welsh Government had proposed a joint venture with Abertis at a meeting in July 2012, but Abertis responded that it would be prepared to sell the Airport to the Welsh Government instead.

2.15 The Welsh Government considered that its options were limited because Abertis wished to sell the Airport rather than retain it or enter a joint venture, and taking into account the outcome of previous efforts to stimulate investment by Abertis. In addition, the tight timescale for completion made it impractical to find a third party for a joint venture to purchase the Airport. The task would have been considerably more complex, uncertain and time-consuming than purchasing the Airport outright, although it would have offered the potential to benefit from external expertise in operating the Airport and the development of new markets, as well as sharing the financial risk. We understand that the Welsh Government had held some initial third party discussions in advance of the formal negotiations with Abertis but that these did not progress further at the time.

Figure 5: Options considered by the Welsh Government through the business case process

Items highlighted in bold text are those highlighted in the full business case as having been shortlisted

1 **Do nothing – the Welsh Government would not intervene and leave the future of the Airport to market forces. The current owners would make decisions on marketing and investment and there would be little if any Government support.**

2 Do minimum – under the option, the Welsh Government would 'continue to press the current owners for further investment' but notes that this approach has not resulted in any 'significant agreement to invest in new route development or infrastructure'.

3 **Purchase the Airport outright, and then**:

   a operate the Airport under a concession;

   b let a contract for the provision of managing and improving the Airport; or

   c **operate the Airport on a standalone basis through a holding company.**

   Under a concession agreement, a third party body would operate the Airport and bear the commercial risks and rewards of doing so. A concession agreement would specify the outputs to be achieved and require the concessionaire to deliver against the outputs in order to receive a financial return. Under option (b), the operator would deliver services for a specified fee and the Welsh Government would bear most of the risks and rewards of ownership.

4 **A joint venture with a commercial partner:** each party would contribute resources and share the risks and rewards of ownership through a new business entity. The following sub-options were included in the business case:

   a with the current owner of the Airport; or

   b **with a third party to buy and operate the Airport, where the Welsh Government commands an equal or controlling majority in the venture.**

5 Lease Cardiff Airport from the current owner and let a service contract for the management of the Airport.

Source: Welsh Government strategic outline business case and full business case for acquisition of the Airport

2.16 We recognise the constraints on the options available, but consider that they should have been more fully explained in the business case. The fact that Abertis declined the Welsh Government's request to consider a joint venture, and the fact that there had been discussions about a joint venture with a third party, were not mentioned in the business case at all. Only the preferred option was fully costed. There was no documented analysis of strengths, weaknesses, opportunities or threats in respect of the two options that were not shortlisted – do minimum and leasing the Airport from Abertis. The do minimum option could, in our view, have been explored in more detail in the business case to recognise the potential for improved joint working given the establishment of the Airport taskforce (paragraph 1.19) and taking account of the sort of opportunities later set out by the Welsh Government in its December 2013 paper on aviation in Wales (paragraph 1.13). More generally, the business case did not consider the opportunity costs of each option – what could have been done with the money if it was not invested in buying the Airport.

Strategic risks were identified, although further sensitivity analysis would have helped to highlight the possible impact of certain risks

2.17 The Welsh Government identified high-level strategic risks in a risk register that formed part of its acquisition project plan. These included a downturn in the economic situation, inability of the Airport to attract airlines that would deliver targeted levels of growth, and changes in the tax regime or legal requirements that would add cost and dampen growth.

2.18 An important consequence of slower-than-expected growth is typically an increase in the amount of external finance needed to fund the growth of a business (in this case the Airport). Treasury guidance suggests that sensitivity analysis should be used to model the impact of such risks. Sensitivity analysis tests the impact of changes in specific factors (eg lower passenger numbers or higher costs) on the net value of the investment.

2.19 The Full Business Case modelled four scenarios that were based on different marketing approaches (paragraph 2.58) but, in our view, further sensitivity analysis would have helped to highlight the possible impact of certain risks. The acquisition business plan was indeed too optimistic about the Airport's growth profile and CIAL's cash requirement has increased substantially compared with the forecasts at the time of acquisition resulting already in a £23 million Welsh Government commercial loan facility (paragraph 3.28).

A formal benefits realisation strategy would have helped to focus greater attention on arrangements for achieving wider social, economic and environmental benefits post-acquisition

2.20 The Green Book emphasises the importance of identifying all the benefits of a project and devising a strategy to achieve them (a benefits realisation strategy). The benefits of the preferred option should be recorded in a benefits register and tracked and evaluated after completion of the project.

2.21 The Welsh Government did not undertake a systematic benefits appraisal or develop a formal benefits realisation strategy for the Airport, although the risks and benefits of two options (buying the Airport and doing nothing) were assessed at a high level by a consultant during the due diligence phase (paragraph 2.50). A more robust benefits appraisal would have helped focus greater attention on wider social, economic and environmental benefits and arrangements for achieving them once the acquisition of the Airport was completed.

Drawing on professional advice, the Welsh Government negotiated a purchase price that was informed by the estimated value of the Airport as a public asset and a range of commercial valuations

2.22 Drawing on professional advice, the Welsh Government ultimately accepted a commercial valuation based on specific assumptions about the overall commercial performance of the Airport – centred on a positive assessment of business growth – and the cost of capital (required rate of return for the investor). The Welsh Government's decision making also took account of the Airport's value as a public asset, its benefit-cost ratio and the wider strategic context, as summarised by some of the work commissioned as part of the due diligence process (paragraphs 2.47 to 2.50). Drawing on the commercial valuations, but applying different assumptions in line with Treasury guidance, the Airport was estimated to be worth £472 million as a public asset when also factoring in the value of transport user and environmental benefits. Officials considered that this valuation justified the price paid on value for money grounds when compared with typical transport projects (paragraphs 2.40 to 2.42).

There are two main methods of commercial valuation, which typically result in lower valuations than those done on a public sector basis

2.23 There is no single accepted method of business valuation for commercial investors. Two methods – a discounted cash flow approach or an earnings multiple approach (Box 3) – are widely used and were applied by professional advisors acting on behalf of the Welsh Government. Treasury guidance for public sector investment projects requires departments to adopt a discounted cash flow approach, but with different assumptions to those that would be likely to be used for a commercial valuation.

Box 3 – The main methods of commercial enterprise valuation

Treasury guidance requires departments to value a public sector investment project on the basis of **discounted cash flows** over the investment period, which is usually around 30 years for capital investment but may be up to 60 years for major infrastructure. Cash flows over this period are projected and the net cash flow (revenues minus costs) for each year is calculated and discounted to present value – the value in today's money – using a specified cost of capital (required rate of return for the investor), which is 3.5 per cent per year before inflation for the first 30 years of an investment period and 3.0 per cent per year for any period after 30 years. The total of these present values is the overall net present value or net present cost of the investment. The financial value of wider public benefits should be included as far as reasonably possible. These might include, for example, the value of savings in travel time from a major transport investment.

For a commercial investment, the cost of capital for a **discounted cash flow** would typically be higher (reflecting commercial risk) and wider public costs and benefits are excluded because these are not relevant to a commercial investor. Future cash flows include the expected terminal value – the value of the business at the end of the investment period. The value of the business therefore depends on the accuracy of the estimates of future profits and value, and the return on investment required. The higher the return required, the lower the up-front value.

An **earnings multiple** approach would value a business based on a multiple of its current or recent underlying earnings (profits). Stock market values are often considered in this way (the price/earnings ratio). Earnings may be assessed over the current year, recent years or projected over the next one or two years. The multiple used will depend on the valuer's assessment of business risk, with a lower multiple (ie a lower value) for high-risk businesses. In general, the multiple should be in line with comparable businesses (those in the same sector and of similar size) and comparable transactions, with a value premium for acquisitions that lead to full control of a company rather than a minority shareholding.

2.24 The commercial value of an investment is typically lower than its value as a public investment. Commercial investors require a higher return on their equity investment than the public sector, particularly in volatile businesses or smaller companies, and they do not count the value of wider public benefits that are of interest to governments. Both factors can make a significant difference to valuation, particularly for long investment periods.

Commercial valuations can vary greatly depending on the assumptions applied, as was the case for the acquisition of the Airport

2.25 Commercial valuations for the same investment can vary greatly depending on the basis of valuation used, the buyer's cost of capital, judgements about market risk, and assumptions about the future profits of the business in question. This was indeed the case for the Welsh Government's acquisition of the Airport, with a number of different approaches and assumptions being applied at different points in the valuation process. The motivation of individual buyers and sellers can also have a great influence on the outcome of negotiations. As such, valuations can vary greatly for legitimate reasons and it can be misleading to give exact valuations or to imply that valuation is an exact science.

The Welsh Government made a formal non-binding offer of up to £55 million in December 2012, at which point an initial commercial valuation report had suggested an indicative valuation range of between £25 million and £35 million but with a higher valuation possible by taking a positive view of future performance

2.26 Following the First Minister's visit to Barcelona to meet Abertis executives in July 2011 (paragraph 1.17), Welsh Government officials made informal enquiries to see if Abertis was open to offers to sell the Airport. Welsh Government documents note that, at that time, Abertis indicated that it was not interested in disposing of its assets but would accept £200 million. Officials felt that the price suggested was so unrealistically high as to be a total rebuttal of the Welsh Government's approach.

2.27 Abertis approached the Welsh Government following another meeting in September 2012, expressing a willingness to sell and asking if the Welsh Government would be prepared to make an offer. The Welsh Government indicated that it would be willing to consider making a formal offer and, in October 2012, suggested to Abertis a valuation of £35 million based on a preliminary assessment using credit agency reports (and subject to due diligence).

2.28 Following further discussions between the parties, Abertis indicated that it would be prepared to move into formal negotiations if the Welsh Government was prepared to consider a price that was 'close to' an enterprise value of between £56 million and £58 million, which was the lower valuation range based on Abertis' own projections for the Airport. The Welsh Government agreed to enter formal negotiations on this basis, and signed a process letter on 3 December 2012 that provided an agreed framework for negotiations and due diligence. This framework included:

a an exclusivity agreement, whereby Abertis would not consider other offers for the Airport while the negotiation process was underway, and both parties would observe strict confidentiality;

b a requirement for the Welsh Government to move quickly and make a non-binding offer for the Airport by 14 December 2012;

c if the non-binding offer was acceptable to Abertis, a joint public announcement of the intended sale would be made by 17 December 2012;

d the provision of relevant information to the Welsh Government and its professional advisors so that they could undertake due diligence and valuation;

e arrangements for discussions between the parties; and

f an indicative timetable that envisaged completion of the sale by the end of March 2013.

2.29 The process was applied as agreed. The Welsh Government made a non-binding offer of 'up to £55 million' for the Airport subject to the results of due diligence work. At this point, officials had already received an initial valuation report from KPMG based on Abertis' own financial projections and published market information. KPMG used the discounted cash flow and earnings multiples approaches outlined above to develop various valuation ranges for the Airport, based on a cost of capital of between 11.5 and 12.5 per cent:

a For the discounted cash flow approach, values that ranged from £10 million to £12 million at the lower end to £34 million to £40 million at the upper end, depending on assumptions about future growth. The highest range reflected Abertis' projections, while the lower ranges assumed shortfalls against these predictions.

b For the earnings multiple approach, values that ranged from £6 million to £7 million at the lower end to £52 million to £55 million at the upper end, depending on the period over which CIAL's earnings were assessed and whether budgeted rather than historical figures were included.

c Taking all information into account, KPMG suggested an indicative valuation range of £25 million to £35 million, which in its opinion reflected the Airport's weak performance relative to historic levels and the low current profitability compared with future profit levels forecast by Abertis.

d KPMG noted that higher valuations could be considered by the Welsh Government on the basis of broader strategic and economic objectives, or if there were benefits to the Airport from having the Welsh Government as its owner that could be reflected in its business plan. In particular, the Airport's value would increase if it could realise synergies through joint operations with the St Athan Airfield.

2.30 The Welsh Government did not have a written negotiation strategy that explained its approach to negotiations. The acquisition project manager told us that officials believed that this offer was the minimum required to persuade Abertis to enter formal negotiations, since the owners had made clear they expected an offer at, or very close to, their counter-offer in November 2012. The Welsh Government was keen to acquire the Airport if possible in order to safeguard its future. It was concerned that the Airport might stagnate or continue to decline under Abertis' ownership or as a relatively small asset within another large company's portfolio of infrastructure investments.

2.31 The Welsh Government has stated to us that it recognised that it did not have the same negotiating strength as a hypothetical investor looking to acquire any airport for purely commercial reasons. The Welsh Government considers that its statutory and general economic development responsibilities gave Abertis a far stronger negotiating position than would have been the case if it had been approached by a private buyer, who might have had a wider choice of options and investment targets. In our view, this situation reinforced the need for a more clearly articulated negotiating strategy, although we have seen some evidence of dialogue between officials about the approach to negotiations as part of the review undertaken by the Permanent Secretary in February 2013.

The Welsh Government received a series of interim commercial valuations, the last of which suggested a valuation range of £20 million to £30 million, but the Welsh Government took the view that some of the assumptions underpinning the valuations were too conservative and made a revised offer of £41 million

2.32 KPMG updated its valuations in February to March 2013 to reflect the results emerging from ongoing due diligence work, using both a discounted cash flow and an earnings multiples approach. The last interim valuation, in early March 2013, suggested a lower indicative valuation range than the initial valuation in December 2012 (£20 million to £30 million instead of £25 million to £35 million). The due diligence work had suggested that underlying profits were somewhat lower than reported by Abertis and, on this occasion, KPMG based the valuation on a 12 to 14 per cent cost of capital.

2.33 The Welsh Government's prime concern was that Abertis would withdraw from negotiations if a revised offer was made that was significantly lower than the non-binding offer that the Welsh Government had made in December 2012. The Welsh Government considered that the updated valuation was too conservative, taking the view that a 12 per cent cost of capital was reasonable while maintaining a market economy operator principle. The updated valuation had also excluded income from the Welsh Government's marketing contract with CIAL (paragraph 1.22), which officials thought could be continued or replaced with income of around £2 million annually from other advertisers if necessary. Such a level of external marketing income would have been higher than previously achieved by the Airport. KPMG's report had considered that this marketing income represented only a short-term boost to the Airport's earnings (and the value of the contract has since been reduced – paragraph 1.23).

2.34 The Welsh Government submitted a formal offer of £41 million to Abertis in early March 2013. Abertis rejected the offer and claimed that the Welsh Government's valuation took an unduly pessimistic view of business risk and growth potential.

Further professional advice that the Welsh Government received in March 2013 modelled a range of scenarios and, based on specific assumptions about future commercial performance and the cost of capital, the Welsh Government concluded that a valuation of around £55 million would be reasonable from a commercial perspective and acceptable to Abertis

2.35 Following receipt of KPMG's last interim valuation report in early March 2013, the Welsh Government instructed KPMG to prepare an advice note showing the result of discounted cash flow calculations for each of York Aviation's scenarios (paragraph 2.58) at various costs of capital, based on assumptions set by the Welsh Government. Accordingly, the calculations included the marketing income that had been excluded previously. KPMG's advice note, issued in late March 2013, did not reach any conclusion on value or a suitable purchase price, and KPMG informed us that it was provided for illustrative purposes only.

2.36 The results of these calculations varied greatly depending on the cost of capital. For example, the value for the base case[12] ranged from £30 million at a 16 per cent annual cost of capital to £39.7 million at 14 per cent, £54.7 million at 12 per cent and £80 million at 10 per cent. At the 12 per cent cost of capital that was ultimately selected by the Welsh Government, the valuations for the other scenarios varied from £0.9 million for the do minimum scenario to £56.0 million for the most favourable York Aviation scenario, which was a slight variation on the base case. The valuation based on Abertis' projections was somewhat lower than the base case, at £44 million.

2.37 KPMG did not include valuations on an earnings multiple basis in its advice note but did report the multiples earned by recent comparable transactions. The Welsh Government asked KPMG only to calculate possible values on the discounted cash flow basis. Officials believed that a valuation based on future profits better reflected the potential of the Airport than one based mainly on historic underperformance. In any case, the discounted cash flow approach better reflects the requirements of Treasury guidance for public sector valuations.

2.38 Alongside the completion of KPMG's work, the Welsh Government commissioned Arup to review the commercial valuation evidence. Arup considered that it was defensible to adopt an assumption of a 12 per cent cost of capital, based on comparable market transactions for regional airports, and to include the same level of marketing income as provided currently (mainly by the Welsh Government). Arup's report identified a commercial value of up to £55.3 million based on future cash flows at a 12 per cent cost of capital.

2.39 On the basis of these valuations, and having obtained legal advice from its in-house lawyers, the Welsh Government concluded that it had credible evidence to support the acquisition of the Airport at the settlement price on market economy operator principles. The Welsh Government recognised, however, that the valuation of a commercial asset of this kind includes an inherent degree of risk and uncertainty.

12 The base case is a variant of scenario 3 in the York Aviation passenger growth forecasts (paragraph 2.58). It involves a focus on expanding passenger numbers through low-fares airline growth, requiring a substantial increase in funding for incentives.

Work commissioned by the Welsh Government suggested that, when valued as a public asset, the Airport was estimated to be worth £472 million, which officials considered justified the price paid on public value for money grounds when compared with typical transport projects

2.40 The Welsh Government also commissioned Arup to assess the public value of the Airport. To derive the public sector valuation, Arup applied a 3.0 per cent to 3.5 per cent cost of capital, in line with Treasury guidance, rather than the 12 per cent ultimately used for the commercial valuation, and extrapolated the results to cover 60 years rather than 25 years. Arup also included estimates for two wider public benefits that were (rightly) excluded from the commercial valuation, using Welsh Government guidance for transport projects and prescribed monetary values for environmental benefits:

a £259 million of transport user benefits over the investment period. This is the estimated present value (2010) of journey time savings and distance-related vehicle operating cost savings.

b £22 million for the present value (2010) of reductions in CO_2 emissions. Arup estimated that 370,000 tonnes of CO_2 would be prevented by residents of Wales using a better-performing Cardiff Airport rather than travelling further afield to competitor airports, in particular Bristol. The valuation did not consider other potential environmental benefits or the potential for the growth of Cardiff Airport to expand air travel overall, leading to an increase in flights and consequent CO_2 emissions.

2.41 The overall result was a valuation of £472 million in 2013 prices. However, the value of the wider public benefits is inherently uncertain.

2.42 Arup recommended that the upper limit of an acceptable value should be determined by applying a benefit-cost ratio in line with commonly accepted standards for transport projects[13], which indicated that ratios should fall somewhere in the range of five to 10, with higher ratios possible for exceptional projects (ie, the benefits of an investment should be five to 10 times greater than its capital cost). On this basis, the maximum justifiable price for the Airport would have been around £94 million, and the acquisition cost of £55 million returned a benefit-cost ratio of 8.6 – towards the top of the normal range. Officials considered that these results justified the price paid for the Airport on public value for money grounds.

13 From the **Eddington Transport Study: The Case for Action**, 2006

On the basis of commercial and public asset valuations, the Welsh Government negotiated a purchase price of £52 million, along with £3.3 million in working capital

2.43 Drawing on Arup's advice, and the final advice note received from KPMG, the Welsh Government made a final offer of £52.0 million to Abertis on a 'nil cash nil debt' basis. In other words, the agreement required Abertis to write off an inter-company loan made by TBI to CIAL, worth around £23 million, but allowed Abertis to keep all cash balances relating to CIAL. As a result, the Welsh Government had to provide cash to fund CIAL's working capital requirements – estimated at £3.3 million – and this was added to the purchase price to make up the £55.3 million overall initial capital cost of the investment for the Welsh Government. Abertis accepted this offer and the parties moved quickly to sign the legally binding sale and purchase agreement on 27 March 2013, which concluded the sale and transferred ownership of the Airport from Abertis to the Welsh Government.

The Welsh Government sought appropriate professional advice and undertook a rigorous due diligence process

The Welsh Government commissioned appropriate professional advice for the due diligence process

2.44 Due diligence is the process by which a prospective buyer assures itself that a possible acquisition of a property or business interest is worthwhile and that any risks involved are acceptable. For a major business acquisition, this typically includes an in-depth analysis of available information about the target's commercial performance, financial position, legal position (property rights, contracts and disputes) and, where appropriate, environmental information.

2.45 The Welsh Government commissioned external advisors to undertake a wide range of due diligence checks, with KPMG as the lead contractor (Figure 6). The advisors were established professional services firms recognised for their expertise on the subjects on which they advised. The advisors were procured through a range of single tenders which were approved through normal Welsh Government procedures, which was a reasonable approach given the need for strict confidentiality and the tight timescales for completion of the work. The various due diligence reports cost a total of £1.04 million[14], which is very similar to the £1.08 million paid by the Scottish Government for due diligence for its purchase of Glasgow Prestwick Airport in November 2013.

2.46 Each contractor had clear terms of reference and produced a written report on its findings. The due diligence work covered all relevant and important risks and involved a thorough analysis of Cardiff Airport's management information. The contractors had access to most of the information that they sought, although some of them commented in their reports that they were unable to complete all of

14 In addition to the reviews listed in Figure 6 , this figure includes professional valuations of the Airport by KPMG and Arup, a review of the strategic context by M&G Barry, and a review of the transitional and separation issues by AIE LLP.

their work because of shortcomings in documentation received from the Airport. However, officials took the view that these gaps did not significantly affect the assurance that they were able to take from the due diligence reports and did not compromise their conclusion that the acquisition did not entail unacceptable risks.

Figure 6: Due diligence work commissioned by the Welsh Government to support its acquisition of Cardiff Airport

Due diligence review	Nature and scope of work
Financial due diligence (KPMG)	Review of financial data, accounting policies, drivers of current and historical trading performance, assets and liabilities (especially pensions), accuracy of historical budgeting and effect of separation from TBI group (itself a subsidiary of the Abertis group). The work involved testing the management accounts presented by the Airport's owners for the due diligence process.
Technical and commercial appraisal (York Aviation)	Detailed analysis of Cardiff Airport's position in the market, passenger numbers and routes, income, operating expenditure and capital spending. Traffic forecasts based on four scenarios from 'do nothing' to a high-growth variant with a major low-cost carrier boosting passenger numbers.
Legal due diligence (Eversheds)	Analysis of legal risks based on review of contracts, property titles, licenses and other legal documentation.
Environmental due diligence (Hyder)	Analysis of environmental risks based on document review and short site visit (no detailed testing involved).
Insurance review (Marsh)	Review of claims, policies and likely requirements in future

Note: The Welsh Government also commissioned professional valuations from KPMG and Arup, which is considered in paragraphs 2.29 to 2.38.

Source: Welsh Government, full business case for acquisition of Cardiff Airport

2.47 The Welsh Government also commissioned a review of the strategic context for the acquisition of the Airport from M&G Barry Consulting. The report found that the Airport had a significant economic impact on the region and that airports generally were vital drivers of economic growth in their areas, especially for inward investment and tourism. The report cited research that Cardiff's international connectivity was relatively poor compared with similar cities in the UK and EU, and below an EU benchmark level that many other European cities attained. The growth of the Airport (however it occurred) would therefore promote economic activity in the Cardiff city region, especially for efforts to establish an international convention centre in Cardiff, to attract major events to South Wales and to attract professional services to the Cardiff Enterprise Zone.

2.48 The report also reviewed the likely impact of major transport investments on the Airport, such as electrification of the Great Western Mainline and the Valleys Lines, and concluded that these would help the Airport if they could expand its catchment area – but only if there were more frequent rail services on the Vale of Glamorgan Line and the Airport had its own railway station. Better road access would also help, and a bus service would be a temporary solution until a high-quality rail link could be established. The South Wales Metro, if developed, would make Cardiff Airport more accessible within its catchment area. However, the report acknowledged that Cardiff Airport could develop and grow even with its current transport arrangements – Bristol Airport had grown rapidly with similarly challenging accessibility.

2.49 The report by M&G Barry also considered the strengths and weaknesses of the Airport currently in relation to its catchment area, terminal, runway, road access, rail access and noise and pollution concerns. The report noted that Cardiff Airport had considerable advantages – there was plenty of terminal capacity with scope for expansion, the runway was longer than Bristol's and was the only one in the south-west of the UK that could be expanded, direct rail access was a possibility in future, and aircraft approached the runway over the sea or unpopulated land, so there was little opposition to expansion. The Airport's weaknesses were its relatively small and low-income catchment area, a dated and inefficient terminal and inadequate rail and bus links.

2.50 The report concluded by summarising the risks and benefits of buying the Airport compared with the 'do nothing' option. Both options had reputational risks, and the purchase option had the risk that costs and liabilities would exceed those anticipated. For benefits, an acquisition would allow the Welsh Government to capture and retain any value created through its investment, and would help to coordinate related projects and develop a coherent economic plan for the region (although the report did not say why or how this would happen). Doing nothing would avoid putting any capital at risk (money that could be used for other projects) but without the benefits of investment in the Airport, and with a negative impact on the marketing and profile of the Cardiff city region. The report did not consider other options.

Due diligence identified some significant risks, but the Welsh Government took appropriate measures to mitigate risks where possible through the sale and purchase agreement

2.51 The overall advice to Ministers was that due diligence had not raised any issues that could not be managed following the acquisition. The key findings are outlined below.

Adjusted profits were lower than headline figures, but the Airport was still able to fund its day-to-day running costs without external finance.

2.52 The financial due diligence work indicated that underlying earnings – after adjusting for non-recurring income and expenditure – were considerably lower than the headline figures reported by CIAL for the due diligence process. They were relatively stable at £800,000 to £850,000 a year in the three years to 31 December 2012, with a budget of £765,000 for 2013. However, the analysis emphasised that income from the Welsh Government marketing contract (paragraph 1.22) made a notable contribution to earnings, with a projected loss in 2013 without this income. Nevertheless, the due diligence indicated that the Airport could fund operating expenditure from its operating revenues in the short term[15], but would need external finance to fund capital expenditure. In addition, net debt (creditors and loans after deducting amounts owed to CIAL by customers) was £5 million more than Abertis reported for the due diligence process, at around £24 million instead of £19 million.

The Welsh Government has taken on the liabilities for CIAL's pension scheme, but has been compensated by Abertis for the scheme deficit at the acquisition date.

2.53 TBI operated a defined benefit pension scheme (a scheme that guarantees a certain level of pension for members) for its employees until the scheme was closed to new members in the 1990s. The scheme continued to operate for existing members, and CIAL retained liability under the scheme for 92 people, of whom only 23 were active members (current employees of CIAL or suppliers with reserved rights). CIAL is legally obliged to meet these pension obligations for all members, whether active or not, in respect of their employment with CIAL before acquisition. Many defined benefit schemes have significant deficits (the value of scheme assets falls short of liabilities to pay future benefits) and this was likely to be the case for the TBI scheme, although precise figures were not available when due diligence was done.

2.54 It is standard practice in company acquisitions for the vendor to retain pension liabilities arising before acquisition or to compensate the buyer for any deficit, and there are various ways of achieving this objective. The Welsh Government accepted Abertis' proposal to transfer the appropriate share of scheme assets and liabilities for all CIAL members into a new scheme run by CIAL, with Abertis paying for any shortfall between the assets and liabilities (ie, the pension deficit).

15 The Airport would continue to need a seasonal cash injection to support the busy summer trading period, estimated at £1.5 million in 2013.

This means that CIAL now has the pension risk for all current and former employees in the defined benefit scheme, for service both before and after the Welsh Government's acquisition of the Airport. The pension deficit at acquisition was actuarially valued at £1.37 million and Abertis paid this amount to CIAL in accordance with the sale and purchase agreement.

2.55 Following acquisition, CIAL transferred current CIAL and Serco staff in the TBI defined benefit scheme into a different defined benefit pension scheme offering broadly equivalent benefits. CIAL has also established its own defined contribution scheme (in which the value of pensions is not guaranteed by the employer, unlike a defined benefit scheme) to replace the scheme previously offered by TBI for staff joining after the defined benefit scheme closed, with an unchanged contribution rate but lower management charges.

Future growth would depend on increases in funding for incentives to attract airlines, and higher maintenance and capital expenditure was also recommended.

2.56 York Aviation carried out a detailed examination of Abertis' projections for the Airport, CIAL's commercial practices and the resulting cost and revenue base. The analysis included a comparison of the Airport's costs and revenues per passenger with industry benchmarks. York Aviation found that aeronautical charges were unrealistically high at Cardiff and were uncompetitive even when incentives were taken into account. The report recommended bringing charges into line with similar airports and emphasised that a significant increase in funding for incentives would still be needed to attract major low-fares airlines or long-haul routes to the Airport, which was essential to restore the Airport to robust growth.

2.57 York Aviation noted that CIAL had responded to falling revenues (driven by falling passenger numbers, not lower charges) by cutting costs and increasing certain charges, such as fees for using baggage trolleys or dropping off customers at the terminal entrance. In particular, maintenance and capital expenditure had been cut, and cleaning had been cut back. The report suggested that these changes were counter-productive and likely to increase costs or damage customer satisfaction in the longer term. The report concluded that an increase in such expenditure would probably be needed, but there were opportunities to make savings elsewhere when contracts came up for renewal and potentially from bringing outsourced functions back in-house. It also suggested that higher levels of commercial income (eg, retail and catering) should be targeted compared with the assumptions in Abertis' financial projections prepared for the due diligence process.

2.58 Based on these findings, York Aviation prepared four scenarios for the future of the Airport, with assumptions that incorporated its conclusions on costs and revenues:

a scenario 1: do minimum, largely a continuation of TBI/Abertis' current route development practices;

b scenario 2: do nothing, implying a withdrawal of current levels of airline support payments;

c scenario 3: focus on expanding passenger numbers through low-fares airline growth, requiring a substantial increase in funding for incentives; and

d scenario 4: as scenario 3, but with a more aggressive pricing strategy that would increase passenger numbers but reduce profits.

2.59 York Aviation included Welsh Government marketing income in its final forecasts (paragraph 2.33). The forecasts showed positive earnings for all scenarios through to 2020, but scenarios 3 and 4 would return much higher earnings than scenarios 2 and 3 by 2020 at the expense of slightly lower earnings until 2016. The do minimum scenario would result in higher earnings than Abertis' projections, but doing nothing would result in much lower earnings than all the other scenarios – only £1.7 million a year by 2020, compared with £7.6 million for scenario 2, £10.3 million for scenario 3 and £7.0 million for scenario 4.

2.60 York Aviation concluded that a variant of scenario 3 was the most likely scenario, yielding annual earnings of £1.6 million in 2014 rising to £3.8 million in 2015 and £9.9 million in 2020. In addition, cumulative capital spending of around £9.9 million would be needed by the end of 2015 and £29.6 million by the end of 2020 – an average of £3.7 million a year, compared to Abertis' projection of £1.2 million a year.

2.61 The Welsh Government commissioned KPMG to prepare a business plan for the Airport based on York Aviation's advice and the most likely scenario (the acquisition business plan – paragraph 3.20). CIAL's business plans have since built on the strategy outlined by York Aviation. The acquisition business plan informed the negotiation process and the wider business case for acquisition.

Due diligence brought to light various weaknesses in environmental management and procedures.

2.62 Hyder's report found that an environmental system was in place and that there were no environmental risks that were serious enough to call the acquisition into question. However, record-keeping and procedures were weak in many respects and there were some instances of poor environmental practice that created pollution risks. Hyder also recommended many administrative improvements including development of environmental policies for certain risks, better labelling and record-keeping, more frequent inspection and following up on recommendations from previous inspections and audits.

The sale and purchase agreement between Abertis and the Welsh Government included appropriate warranties and other clauses to address specific legal risks.

2.63 The legal due diligence report identified various legal risks relating to contracts, leases and regulatory issues. Most of these issues were relatively low risk and the more important issues were dealt with through appropriate clauses in the sale and purchase agreement between Abertis and the Welsh Government. These included warranties and indemnities to limit the liability of the Welsh Government for any losses due to problems arising before acquisition. The Welsh Government has not had to pursue any of these warranties or indemnities to date.

The Welsh Government commissioned specific advice on governance, separation and transition issues.

2.64 The Welsh Government commissioned AIE LLP to advise on separation and transition issues and how the transition should be handled. The acquisition meant that CIAL would need to replace services provided by TBI as the holding company and would need to manage media interest and any concerns of suppliers, staff and other stakeholders. Jon Horne, a former Managing Director of the Airport and a partner in AIE LLP, undertook the work and concluded that most risks were low, and other risks could be mitigated. He developed a transition and separation plan to be implemented in the first 100 days after completion covering business development, creating a sense of change, branding and communications, stakeholder relations, governance and business continuity, and synergies and efficiencies.

2.65 The Welsh Government also asked Eversheds to advise on governance arrangements for CIAL once it owned the Airport. Eversheds recommended that Ministers establish a holding company to manage its investment and drafted a Management Agreement to regulate the relationship between CIAL and its holding company. Ministers accepted the advice and the holding company – WGC Holdco Ltd – was established in time for the acquisition.

Part 3

The Welsh Government has established sound governance arrangements to manage its investment and the Airport is now likely to grow significantly, although progress is slower, and the need for external finance greater, than forecast at the time of acquisition

3.1 This part of our report considers developments since the Welsh Government's acquisition of the Airport in March 2013. We have considered the setting up and operation of the Welsh Government's holding company arrangements and the overall progress that the Airport is making against its business plan and the Welsh Government's own objectives. CIAL has developed annual business plans for approval by Holdco, but was not involved in setting the acquisition business plan that was commissioned by the Welsh Government to inform its purchase of the Airport. Our work is limited to those matters within the remit of the Welsh Government and its holding company, including wider issues such as transport access. We have not examined the detailed day-to-day operations of the Airport itself.

Officials followed legal advice in establishing a holding company to manage its investment at arm's length from the Welsh Government

The Welsh Government obtained legal advice on governance arrangements and established a sound governance system in good time for the acquisition

3.2 The Welsh Government took legal advice during the due diligence process about appropriate governance arrangements for its ownership of the Airport. The advice recommended that the Welsh Government establish a holding company to own the equity investment in the Airport, with a Management Agreement to regulate the relationship between the holding company and CIAL. The purpose of this arrangement was to ensure that CIAL operated as a commercial enterprise at arm's length from the Welsh Government, with Ministers clearly removed from day-to-day operational matters. Officials considered that such arrangements would largely protect the Welsh Government from liability for the actions or omissions of CIAL and would emphasise that it was acting as a commercial investor.

3.3 Acting on this advice, the Minister for the Economy, Science and Transport agreed to establish Holdco to own and manage the Welsh Government's equity investment in CIAL. Holdco has a single share, owned by the Welsh Ministers, and in turn owns all the shares in CIAL purchased by the Welsh Government. This holding company model is common in the private sector and was adopted by the Scottish Government for Glasgow Prestwick Airport.

3.4 A Management Agreement sets out the responsibilities of each party (Figure 7) and provides Holdco with a reasonable level of control over CIAL without impinging on its operational autonomy. In particular, the agreement enables Holdco to influence the appointment of CIAL's board of directors, to approve its business plan and budget, and to monitor its performance.

Figure 7: Responsibilities of CIAL and Holdco under the Management Agreement

The Management Agreement sets out the framework within which CIAL and its board shall operate, including reporting responsibilities, limits of delegations and governance

Appointment of directors

The CIAL board appoints and may remove non-executive directors, including the Chairman, but requires the prior approval of Holdco in each case.

The CIAL board appoints the company's chief executive officer, subject to Holdco's veto, and also appoints other executive directors.

The chief executive officer is a member of the Board and is responsible for the day to day management of the company.

Holdco has an overarching right, at any time, to appoint or remove directors from the CIAL board.

Responsibilities of the CIAL board

Provide effective oversight – set strategic direction and challenging objectives.

Promote high standards of safety and security, customer service, propriety and value for money.

Ensure that company's activities are conducted efficiently and effectively.

Establish sub-committees of the board to oversee an appropriate system of internal control.

Arrange external audit of the company's accounts and ensure the accounts are true and fair.

Business plan and budget

CIAL prepares an annual business plan for the two years ahead which must consider all relevant factors associated with the business.

CIAL prepares an annual budget for the 12 months ahead, at the same time as the business plan.

Holdco's approval is required before the business plan and budget may be implemented.

Monitoring and reporting

CIAL to provide monthly management accounts to Holdco with information on performance against the operating budget.

CIAL to notify Holdco promptly of any likely significant deviation from the operating budget.

CIAL to report each month to Holdco on compliance with regulatory matters.

Consent matters

Certain decisions require the consent of Holdco before CIAL may implement them – these are known as consent matters.

35 consent matters are listed in the agreement, covering a range of issues including: changes to share capital, formation of subsidiary companies, entering any joint venture or partnership, issuing guarantees or charges over the company's assets, borrowing and lending outside prescribed limits, external audit and accounts, credit agreements for supply of goods and services, acquisition of property, asset disposals, terms and conditions of service for directors, pensions.

Holdco is required to consider and (where appropriate) to approve consent requests promptly.

Source: Management Agreement between Holdco and CIAL

3.5 The Welsh Government’s Internal Audit Services examined the establishment and operation of Holdco in 2013 and reported in March 2014. The review covered the establishment of Holdco, appointment of its board members, administration of Holdco business and procedures for performance managing CIAL. The internal audit found that the Welsh Government had obtained appropriate advice about the holding company model and that governance arrangements were sound, although it recommended or led to some improvements as noted below.

Holdco is staffed entirely by civil servants and might benefit from an external member to provide an independent perspective

3.6 The Holdco board comprises three senior Welsh Government civil servants appointed by the Director General of the Department of Economy, Science and Transport in the Welsh Government. The three members were assessed as having the required ability to scrutinise and challenge reports and prior experience of dealing with businesses. The board is chaired currently by the Department’s Director of Transport and ICT Infrastructure. The proposal approved by the Minister envisaged the appointment of CIAL’s Chairman as a non-executive member of the Holdco board, but this appointment was never made.

3.7 The Welsh Government’s internal audit of Holdco found that the Welsh Government had observed appropriate standards in appointing members of the Holdco board. However, the audit recommended that the Welsh Government review the composition of the board and seek to appoint independent and experienced non-executive directors. In response, the Welsh Government agreed to conduct a review by August 2014 but this review has not been completed. The Scottish Government’s holding company for Glasgow Prestwick Airport is chaired by an independent non-executive director, recruited through open competition (who also chairs the airport operations company board). The Chief Executive of Glasgow Prestwick Airport is also a member of the holding company board.

The Minister appointed the former Chairman of CIAL without a competitive process and the Welsh Government had a leading role in the other initial non-executive director appointments

3.8 Welsh Government officials have stressed that special arrangements were needed for the initial appointments of Chairman, other non-executive directors, and Chief Executive in order to ensure that the Airport had appropriate leadership at a critical time in its development. As such, the Welsh Government took a leading role in overseeing these initial appointments. The Minister appointed Lord David Rowe-Beddoe, a former Chairman of the Welsh Development Agency and the Wales Millennium Centre, in March 2013 as the Chairman of CIAL in the event that the acquisition went ahead. This was the Minister’s personal appointment; as a private commercial company, CIAL is not covered by the usual arrangements that require open competition for the appointment of board members.

3.9 The Welsh Government identified four other non-executive directors with the approval of Holdco and presented these to Lord Rowe-Beddoe, so that they could be appointed as non-executive directors in April 2013 for a two-year term. All of the new directors had extensive business experience at a senior level in various sectors, including one with significant involvement of acting as a consultant to regional airports. A further non-executive director with property experience was appointed in September 2013. Two of the directors were re-appointed in April 2015 for a further two-year term.

3.10 Jon Horne was appointed as CIAL's Chief Executive in March 2013 and prior to Lord Rowe-Beddoe's appointment. The appointment was made by the Welsh Government. The Welsh Government believed that Mr Horne was the obvious choice for the role because he had previously been the Managing Director of the company between 2001 and 2007, overseeing the growth of the Airport to its peak, and so had an in-depth knowledge and experience of the business. He was also available to take the job immediately and would be able to oversee the critical transition period from the outset. Mr Horne stepped down as Chief Executive in September 2014. CIAL confirmed the appointment of its new Managing Director in December 2015.

3.11 We acknowledge that special arrangements were needed for these initial appointments to ensure that the Airport had appropriate leadership at a critical time in its development. In future, and consistent with the principle of operating at arm's length, the CIAL board will appoint non-executive directors, including the Chairman, subject to the approval of Holdco. However, the appointment of the incoming Chair, Roger Lewis, was directed by Holdco, drawing on its power to appoint non-executive directors as set out in CIAL's articles of association and the Management Agreement with CIAL. Mr Lewis had announced that he intended to step down as Chief Executive of the Welsh Rugby Union at around the same time that Lord Rowe-Beddoe's term as Chairman came to an end, and the Welsh Government was keen to offer the position of Chairman to Mr Lewis before he pursued other opportunities. Holdco considered that Mr Lewis' previous leadership of the Cardiff Capital Region, his record at the Welsh Rugby Union, and his global business experience would be highly valuable to the Airport and justified making the offer quickly without a competitive process.

3.12 CIAL has considerable discretion over the appointment of executive directors and Holdco was not actively involved in the process of recruiting the new Managing Director, although it had been consulted on the process and candidate brief and provided an independent member for the selection panel. Holdco has not been involved in the appointment of a new Finance Director/Company Secretary.

The holding company has an effective working relationship with the Airport operating company and has an appropriate level of control over the operating company, although there is scope to improve performance monitoring

3.13 The Holdco board meets regularly, usually every one to two months and more frequently if required. The board considers progress against the business plan using the information supplied by CIAL, and reviews its own risk register based on its assessment of the Airport's position. The board also considers any matters that require its consent such as approval of the business plan (Figure 7). The Chairman of Holdco attends CIAL board meetings as an observer and there are occasional joint meetings of the two boards to review performance, giving Holdco a further insight into the Airport's operations and its progress against the business plan.

3.14 The Holdco board is supported by a secretary, an official in the transport division of the Welsh Government, who provides administrative support and ensures that the company meets key requirements such as the filing of audited annual accounts. The internal audit reviewed the administrative arrangements and concluded that they were sound, except for some weaknesses in record-keeping that were attributed to staff absence. Holdco also clarified the Management Agreement and strengthened procedures in some respects during the course of the audit in response to feedback from the auditors.

3.15 Holdco receives the same papers as the CIAL board, which provides Holdco members with comprehensive information about the Airport's operations and performance. These reports include:

a Management accounts, which comprise:

- a comparison of income and expenditure with the approved budget and the previous year;
- an analysis of passenger numbers for each airline, including comparisons with the budget and the previous year; and
- a review of capital expenditure, cost savings and cash flow.

b An update on route development activity, covering all prospects for new routes.

c An update on marketing activity, including promotion of routes on behalf of airlines and statistics on access to the Airport's website and social media channels.

d An operations report covering the outcome of inspections by regulators, health and safety assessments, environmental testing and customer feedback.

e A report from the Managing Director with a commentary on the main issues and developments since the last board meeting.

3.16 CIAL also produces a detailed risk register but Holdco does not routinely see it, relying on the other reports to draw out any key risks for its own risk register as well as discussing key risks at quarterly joint meetings of the Holdco and CIAL boards. Holdco has followed up key issues such as establishing a replacement pension scheme.

3.17 Holdco has not set key performance indicators for the Airport, although it intended to do so for monitoring purposes when Holdco was first established. There are budgets for income, expenditure and passenger numbers but the information provided to Holdco does not include performance measures for other aspects of the Airport's activity. Given the volume of information provided by CIAL and the breadth of the Airport's activity, it would be helpful for Holdco to focus on a relatively small number of key performance indicators that clearly relate to the main objectives in the Airport's business plan. Currently, the Holdco secretariat does not summarise or analyse the management information provided by CIAL.

3.18 Neither CIAL nor Holdco is currently obliged to produce an annual report (other than its annual accounts) to summarise progress over the year. An annual report would provide an opportunity for both CIAL and Holdco to take stock of progress against the business plan, in particular against wider sustainable development objectives that are not currently covered in the operational detail of the monthly reports provided to the companies' boards.

3.19 Our work indicates that CIAL and Holdco have a positive and effective working relationship, a view shared by Holdco and CIAL board members whose views we obtained as part of our audit. Both parties have developed a better understanding of each other's requirements over time, aided by the introduction of regular joint meetings of the Holdco and CIAL boards.

The Airport has a growth-oriented business plan, although the need for external finance is greater than forecast at the time of acquisition and commercial progress will be slower than initially expected

The Airport has a growth-oriented business plan aimed at delivering the Welsh Government's expectations for the Airport, although investment plans have been scaled back since acquisition

3.20 The Welsh Government commissioned KPMG, as part of the due diligence process, to prepare a business plan for the Airport (the acquisition business plan). The plan was intended to document the Welsh Government's plans for the Airport; it set out a commercial strategy (Figure 8) and financial projections that provided a framework for CIAL to develop subsequent, more detailed business plans. The plan was also intended to demonstrate that the Welsh Government was acting as a commercially minded investor that was interested in securing a market return on its investment over the long term.

Figure 8: Main elements of the commercial strategy for Cardiff Airport set out in the acquisition business plan

The strategy was set in the context of a serious decline in passenger numbers since 2007 and the need to recover leakage (lost business from the Airport's catchment area):

Secure a credible low cost operator to boost passenger numbers.	Re-engage existing airlines, especially those serving important hub airports.	Secure long-haul routes to the Middle East and North America in the near to medium term, when sure of their long-term sustainability.
Improve airport facilities – cosmetic initially, with more substantial alterations later on that will help increase retail revenue by reconfiguring the terminal building.	Airport-wide commitment to customer service and quality, engaging with all suppliers, servicing companies and concessionaires to improve service.	Comprehensive communications strategy, including new media in all its forms, to reconnect with lost markets and with the people of Wales more generally.

Source: Acquisition business plan, 2013 (KPMG)

3.21 The plan was based on the most likely scenario in York Aviation's technical and commercial due diligence report (paragraph 2.60) and assumed a substantial increase in passenger numbers from one million in 2012 to 2.2 million in 2020, followed by more modest but steady growth to 3.3 million in 2037, and a corresponding increase in income and earnings. The plan acknowledged that incentives might be needed to attract a low-cost carrier to drive growth.

3.22 CIAL has prepared annual business plans for each financial year (ending 31 March) in accordance with the Management Agreement. The format and content of the business plans has varied over time, but the main themes have been consistent with the acquisition plan (Figure 8). In addition, all plans prepared by CIAL refer to a policy of bringing outsourced services back in-house where a business case could be demonstrated.

3.23 Each of CIAL's plans included a statement of objectives, a business strategy in line with that outlined in the acquisition business plan, an operating budget for the year ahead and, until 2015, financial and passenger number forecasts for the following four years. In 2015 CIAL prepared five-year projections as in previous years but these were not included in the final business plan at the request of Holdco. Holdco considers that a two-year horizon offers greater certainty on which to base decisions as longer-term projections can be inaccurate and misleading. We note, however, that Glasgow Prestwick Airport has prepared a long-term financial plan that includes projections at least eight years ahead.[16] While we recognise that Holdco might not wish to formally approve plans beyond the two-year period, we consider that it should nevertheless be scrutinising CIAL's financial prospects over a longer horizon. We are concerned, therefore, at the removal of these projections from the business plan. In October 2015, the Welsh Government tendered for an external independent review of the Airport's financial health and likely future finance requirements, with a final report expected by spring 2016.

3.24 CIAL submitted its first post-acquisition business plan to Holdco in June 2013. The plan included more ambitious targets for income than those in the acquisition plan, based on securing a major low-cost carrier in 2015-16 rather than 2016-17. CIAL also planned an extensive programme of capital works to reconfigure and refurbish the terminal building, improve surface access and introduce new security equipment. The company wanted to press ahead with plans to reconfigure the terminal building to improve the Airport's passenger handling capacity and increase the size of the airside area, where passengers spend their time after passing through security checks. The reconfiguration would have brought Cardiff into line with other airports which are designed to maximise the airside space and encourage passengers to shop before boarding their flights, thus increasing the amount of commercial income flowing to the Airport. The acquisition business plan had envisaged that capital expenditure would be limited initially to ongoing maintenance, dealing with a maintenance backlog and installing essential security equipment, with substantial alterations following in 2015 to 2017 when the Airport had started to grow.

16 Auditor General for Scotland, **The Scottish Government's purchase of Glasgow Prestwick Airport,** Audit Scotland, 24 February 2015, p27

3.25 There were several drafting discussions between CIAL and Holdco regarding CIAL's 2013 Business Plan. Key issues that were discussed were plans to attract a low-cost carrier, capital investment plans and the presentation of the plan. CIAL submitted a final version of the business plan in September 2013 that addressed many of these concerns but adopted broadly the same strategy and the same scale of capital investment, to be financed by a commercial loan from the Welsh Government. Holdco approved the plan but made clear that it had misgivings about the strategy, and emphasised that it was not approving the loan that would be needed to finance the capital investment included in the plan. The decision on the loan would be made elsewhere in the Welsh Government and would require a separate business case (ultimately the Welsh Government approved a smaller loan based on a scaled back capital programme – paragraph 3.30).

3.26 Holdco discussed its expectations for the business plan with CIAL executives before the 2014 and 2015 plans were submitted, ensuring that the process of approving these plans worked more smoothly than in 2013. Both plans were approved in the first month of the financial year to which they related.

3.27 The 2014 and 2015 business plans included more detail about marketing, sales, communications and initiatives to improve the Airport's environmental performance. The marketing and communication plans, in particular, have developed over time and become more specific and targeted. Both plans have scaled back the scope of capital investment to cover improvements to approach roads, refurbishment of the existing building, replacement of essential safety and security equipment, and dealing with the maintenance backlog. The reconfiguration of the terminal building has been deferred. The 2014 plan included a programme of efficiency savings to cut operating costs.

In common with many airport operations, CIAL is requiring a cash injection to deliver its business plan and the Welsh Government has approved since acquisition commercial loan facilities to the value of £23 million

3.28 Many commercial airport operations carry significant debt to help finance their activities and realise business development objectives. The acquisition business plan indicated that £2.7 million of external finance would be needed before the Airport became cash-positive. The external finance requirement estimated by CIAL now stands substantially higher, having increased in each subsequent business plan. The Welsh Government has provided commercial loan facilities totalling £23 million, and CIAL's projections indicate that additional finance will be needed through to March 2020. The Welsh Government has commissioned a review of the Airport's finances to assess its financial position (paragraph 3.23). As part of the review, the Welsh Government is also validating the terms of the loan agreement. The interest rate applied to the loan is based on standard benchmarks set by the European Commission, taking into account the Welsh Government's assessment of CIAL's credit rating and the amount of collateral available to support the loan.

3.29 Under UK Government accounting rules, any borrowing by CIAL counts against the Welsh Government's borrowing limits because CIAL is a subsidiary of the Welsh Government, even though CIAL is not itself a public authority. This is the case even if the loan is provided by a third party and not by the Welsh Government. The Welsh Government has therefore decided that it should provide any external finance directly in order to minimise financial risks, and alternative lenders such as banks were not considered. Audit Scotland's report on the acquisition of Glasgow Prestwick Airport by the Scottish Government in November 2013 noted that the Scottish Government had budgeted to make loans of £25.2 million by 31 March 2016.

3.30 CIAL envisaged a requirement of £18 million in its 2013 plans (£10 million in the form of grants) principally to help finance £19 million of capital spending over the first five years from acquisition. However, the Welsh Government asked CIAL to defer non-essential work to reconfigure the terminal building, which it considered to be unnecessary until the Airport had started to demonstrate strong growth. We consider this to have been a reasonable decision in the context of low passenger numbers and uncertain future growth. The Welsh Government provided a loan facility of £10 million in November 2013, to be drawn down as required, at commercial rates of interest. At 30 November 2015, all of this loan had been drawn down.

3.31 The 2014 business plan requested an additional loan facility of £14 million to be made available by the end of March 2015. The 2015 business plan estimated that CIAL would need to raise further capital to finance the cost of incentives for route development, which was much greater than expected in previous plans. The Welsh Government had agreed in principle to provide a further loan facility of £13 million in November 2014, which was intended to cover the cost of incentives for route development. The Welsh Government has recently consolidated both loan facilities under a single agreement.

3.32 Our analysis of the information supplied to Holdco by CIAL indicates all of the projected finance requirement is accounted for by capital spending, route development incentives and delays in realising savings that had been expected from joint working with the St Athan airfield. The Airport still expects to cover its day-to-day operating costs from operating revenues, but capital expenditure and new route development are fundamental aspects of CIAL's business strategy and need to be funded if the business is to grow. The Airport has initiated a programme of operating efficiency savings and has raised its commercial income above the levels projected in the 2013 business plan, which has helped to improve cash flows and reduce the overall financing requirement.

3.33 CIAL is eligible to apply for business support from the Welsh Government in the same way as other businesses in Wales and the Welsh Government has emphasised to us that it deals with loan applications from CIAL consistently with other business loan applications. There is no standard application process through which such loans are provided, with each case considered on its merits and subject to availability of funds and due diligence. Applicants provide a business plan which is assessed by officials and loan awards are approved by the Minister for Economy, Science and Transport. The value of CIAL's loan facility is high relative to others that have been provided by the Welsh Government to commercial organisations. However, the Welsh Government has indicated to us that there are a number of loans that are being considered or have been previously offered which are well above this figure.

3.34 The loans to CIAL are being provided from the Financial Transactions budget, provided by the Treasury in addition to the Welsh Government's block grant in order to fund income-generating investments. The loans are expected to provide several millions pounds of interest income to the Welsh Government in the period to March 2020. The timing and profile of repayments will depend on when the Airport becomes cash-positive.

3.35 The Welsh Government is working on the assumption that it will hold its investment for the long term, although it remains open to proposals for investment and joint working. However, any such interest has not, as yet, resulted in any formal negotiations.

3.36 A joint venture involving a significant equity investment would reduce the financial demands on the Welsh Government by providing an alternative source of funding for the Airport's growth. In addition to equity funding (ie, payment for shares in CIAL), a joint venture could potentially remove CIAL from the scope of public sector accounting requirements altogether, whilst still allowing the Welsh Government to retain a non-controlling stake in the Airport if it wished. This would enable CIAL to secure external loan finance from sources other than the Welsh Government without affecting the Welsh Government's capital budgets.

Passenger numbers have fluctuated since acquisition but are likely to grow substantially now that Flybe has established a base at the Airport, although progress against the overall business plan will be slower than forecast at the time of acquisition

3.37 Following acquisition, CIAL focused initially on working with existing carriers to encourage them to develop new routes or increase their capacity on existing routes by increasing the frequency of services, increasing the size of aircraft or running seasonal flights for a longer period during the year. Meanwhile, the Airport continued its efforts to secure a major low-cost carrier to base aircraft at Cardiff and to secure long-haul services to the Middle East and North America. This route development activity involves analysing the market to identify opportunities, contacting appropriate airlines to discuss these opportunities, and offering incentives where necessary to secure new routes. The Airport has also exhibited at the World Routes Summit in 2013, 2014 and 2015 in order to generate interest among potential customers.

3.38 CIAL reported an increase in passenger numbers of 8.5 per cent in the year to 31 March 2014, with total numbers increasing from around 995,000 to 1.079 million. The Airport maintained traffic levels on its core routes and persuaded some existing carriers to increase capacity or introduce new routes. For example, Thomas Cook increased its capacity during the summer season, Vueling extended its Alicante and Malaga services through the winter and cruise flights to the Caribbean were re-introduced through various charter companies. CIAL secured Cityjet to run services to Edinburgh, Paris and Dublin when Flybe withdrew these services in December 2013 as part of a wider retrenchment exercise following a profit warning. CIAL had projected this increase and the Airport ended the financial year within one per cent of its budgeted figure for passenger numbers.

3.39 This progress was reversed in 2014-15, with passenger numbers declining by 6.9 per cent to 1.005 million, only marginally above the numbers recorded in the final year of Abertis' ownership and some seven per cent below forecast. Some of the new routes or additional capacity did not perform as well as expected and this, together with reorganisation in key airlines, meant that some services were withdrawn or scaled back, despite marketing campaigns that aimed to increase sales. Flybe withdrew its services as part of its internal restructure and reorganisation, leading to a reduction in passenger numbers that was only partly replaced by other carriers. The Airport responded well to the NATO summit in September, drawing praise from the organisers and handling 1,879 passengers over a three-day period. However, the effect was not sufficient to replace a decline in passenger numbers over the remainder of the year.

3.40 The outlook for 2015-16 is more positive now that CIAL has signed a commercial agreement with Flybe to base two aircraft at Cardiff and become the Airport's main low-cost carrier, starting in June 2015. The agreement was negotiated with Flybe in late 2014 and early 2015 and reflects the airline's return to expansion following a change of management and a retrenchment of services in 2013 (paragraph 3.38). Flybe will operate services to at least 10 destinations with a frequency of between four and 26 flights a week on average. The agreement requires Flybe to operate services at a certain level for at least 10 years.

3.41 The initial destinations (Figure 9), which will be subject to regular review, have been selected to include routes that provide strong opportunities to develop business and leisure tourism to Wales. CIAL expects the agreement with Flybe to result in a substantial net increase in passenger numbers by the end of the 10-year period. These forecasts take into account that Cityjet has ended services from Cardiff in response to Flybe planning to run services on the same routes.

3.42 CIAL's view, after taking professional advice, was that the agreement with Flybe would provide an appropriate commercial rate of return consistent with the market economy operator principle. As is usual with such commercial agreements, there is a degree of financial risk for CIAL in the event that sales fall below the projected level, but the view of CIAL and Holdco is that the agreement is based on conservative assumptions and that robust measures are in place to mitigate foreseeable risks.

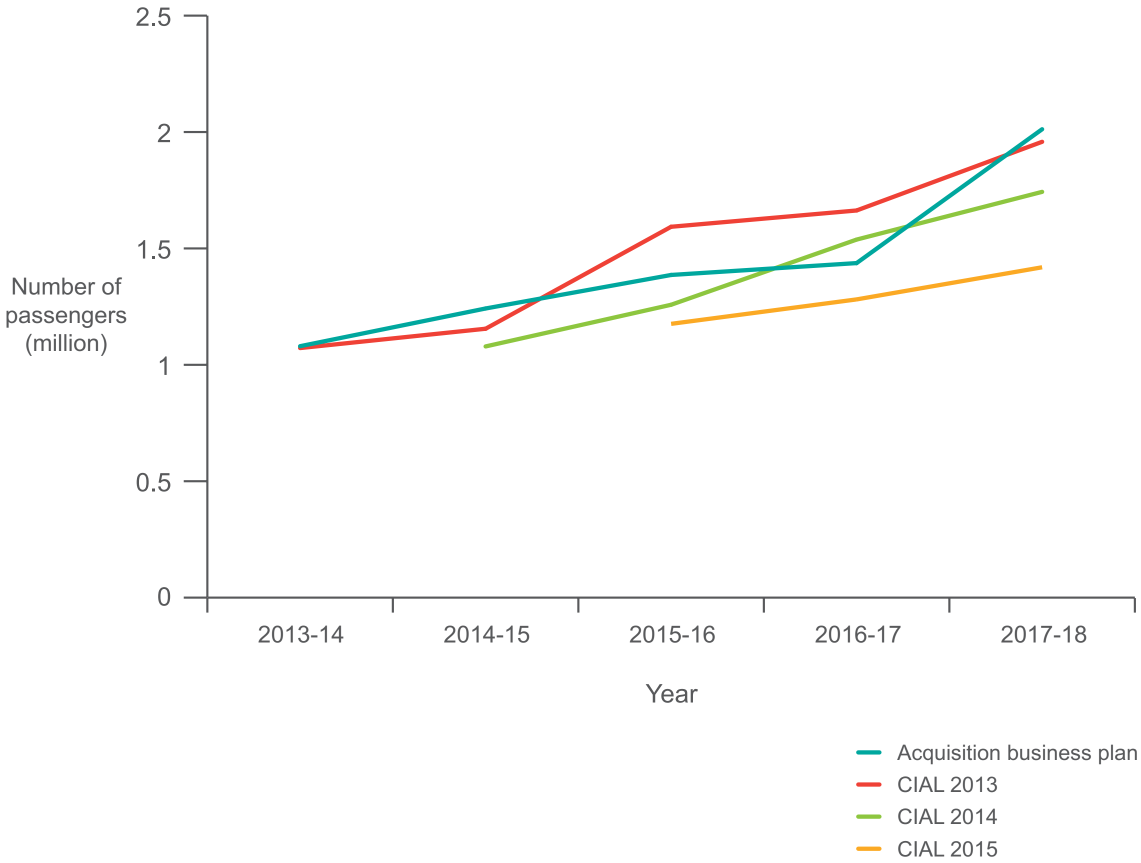
Figure 9: Flybe initial destinations from Cardiff (in order of annual capacity)

Note: Since the agreement was signed, Flybe has announced additional services to Belfast, Chambery and Geneva (the last two of these services in winter only).

Source: Business case for Flybe agreement, 2015 (CIAL) and Cardiff Airport website

3.43 The latest CIAL business plan and budget is for passenger numbers to rise to around 1.4 million in 2017-18. These estimates indicate substantial growth, but are well below the levels envisaged in the acquisition business plan, which had informed the valuation of the Airport. In hindsight, it seems clear that the plan was over-optimistic about the pace of growth that Cardiff Airport could achieve in the face of strong competitive challenges (Figure 10). CIAL managers told us that the market remained tough and the business plan now reflected more prudent assumptions about future growth.

Figure 10: Projected passenger numbers in business plans, 2013-14 to 2017-18



Note: The acquisition business plan is based on the 'most likely' scenario in York Aviation's due diligence report.

Source: Welsh Government and CIAL business plans for Cardiff Airport

3.44 CIAL expects that the arrival of Flybe will boost confidence in the Airport among other airlines and assist its efforts to secure long-haul routes to the Middle East and the east coast of North America, which are priorities for route development activity. The Airport is seeking to capitalise on its advantages, which include:

a a catchment area with significant leakage to other airports, indicating considerable growth potential for airlines able to offer services to in-demand destinations at competitive prices and frequencies;

b a 2,392 metre runway, which enables direct flights to medium-distance destinations;

c no restrictions on night flights (the normal flight path approaches over the sea and agricultural land, minimising aircraft noise nuisance for local residents);

d a terminal and runway with plenty of capacity for expansion;

e recent improvements to the security screening area and refurbishment of the terminal building, together with other initiatives to improve customer service; and

f introduction of an express bus service to Cardiff city centre to improve accessibility by public transport.

3.45 An individual airline's decision on whether to run services from Cardiff is likely to depend on a range of factors, including:

a the size and propensity to fly of the local catchment area, and its overlap with the catchment areas of neighbouring airports;

b an airline's perception of the Airport's potential for growth and the position of its competitors, which will inform its judgement about whether it would miss an opportunity by not investing; and

c issues specific to the airline such as its business strategy and availability of aircraft to serve new routes – the Airport expects many airlines to take delivery of new aircraft in 2016-17, providing greater opportunities for new business at that time.

3.46 CIAL executives told us that the quality of infrastructure and transport links to the Airport need to be adequate, but are regarded as secondary considerations. For passengers within the catchment area – the Airport's main target – the decision to fly from Cardiff will depend primarily on the price and convenience of the services available to their chosen destination rather than the ease of getting to the Airport. CIAL is pursuing a public relations and marketing strategy to raise the profile of the Airport to ensure that residents of the Airport's catchment area at least consider Cardiff as an option when they wish to fly somewhere.

The Airport will fall short of the Welsh Government's medium-term profit expectations at acquisition

3.47 The Welsh Government based its acquisition business plan on net income (after incentives for airlines) of £95 million and underlying earnings of £21 million in the five-year period following acquisition. Subsequent business plans from CIAL have progressively reduced these forecasts. For the 15-month period to 31 March 2014[17], CIAL reported an underlying loss of £1.17 million. For 2014-15, CIAL reported an underlying profit of £41,000.

3.48 The reasons for the change in the five year forecasts to March 2018 include:

- a the cost of incentive development funding to attract new carriers;
- b the lower-than-expected increase in passenger numbers, reducing the Airport's income from traffic charges that are typically based on the number of departing passengers;
- c lower-than-anticipated marketing income from the Welsh Government – the acquisition business plan had assumed this would continue at the same level as in the two years before acquisition, but in fact it has reduced (paragraph 1.23); and
- d lower-than-anticipated savings/income from joint working with St Athan.

3.49 Commercial income per passenger (from sources such as the car park, retail and catering outlets in the terminal building and the executive lounge) is expected to be higher than the levels forecast in the acquisition business plan, although overall income will still be lower due to the reduction in forecast passenger numbers over the 2013-18 period. CIAL has taken steps to raise its commercial income by re-negotiating contracts as they have come up for renewal, strengthening marketing and amending prices for services that it provides directly. Overall, actual commercial income was slightly above the projected figures in both 2013-14 and 2014-15.

3.50 Operating expenditure is now projected be within two per cent of the figures projected in the acquisition business plan for the five-year period, despite the decline in projected passenger numbers. Most of the Airport's costs are largely fixed with a weak link to changing passenger numbers. Nevertheless, the Airport has begun a programme to make financial efficiencies and plans to make some savings by bringing certain outsourced functions back in-house where there is a business case to do so.

17 Before Welsh Government acquisition, CIAL reported its accounts on a calendar-year basis. Following acquisition, the accounting period was aligned with that of the Welsh Government (31 March year-end) meaning that the first post-acquisition accounts covered the period 1 January 2013 to 31 March 2014.

There is no formal plan to realise wider benefits from the acquisition of the Airport, but there is closer working at operational level and improvements in environmental procedures and equality

There is no formal benefits realisation plan, but the Airport is working more closely with relevant public sector stakeholders than before acquisition

3.51 The Welsh Government did not prepare a formal benefits realisation plan as part of its business case for purchasing the Airport (paragraph 2.21). A documented benefits realisation plan would have provided a useful framework for identifying potential benefits from the acquisition and managing them after the purchase to ensure that they were delivered. Nevertheless, the Welsh Government and CIAL have built on the progress of the taskforce to work together more closely in several respects as set out below.

Working relationships

3.52 There is closer joint working with the Welsh Government in the following respects:

a The secondment of a senior civil servant from the Welsh Government to CIAL for two years, providing the official with a commercial perspective while bringing project management experience and a public sector perspective to CIAL (paragraph 1.20).

b The Welsh Government has named an official in the Department of Economy, Science and Transport to act as a key contact for the Airport and de facto relationship manager. The official meets the Managing Director or Chief Executive of the Airport every six to eight weeks to discuss issues of common interest. He also convenes a group of Welsh Government officials with an interest in the Airport (on transport, tourism promotion and marketing) to share relevant information and agree on actions required to make progress on issues of interest.

3.53 The Airport appears to have a positive relationship with the Vale of Glamorgan Council and the local community. Cardiff Airport has an Airport Consultative Committee which brings together Airport managers with community and business representatives to discuss matters of common interest. We consulted members of the committee as part of our study who told us that relationships with the Airport were broadly positive, that they welcomed its purchase by the Welsh Government and were keen to see expansion of services and passenger numbers. The senior managers that we interviewed at CIAL also felt that relationships with the local community were good and had improved since 2012.

Transport issues

3.54 The Minister of Economy, Science and Transport announced in June 2013 that an express bus service would be established from 1 August 2013 to connect the Airport with Cardiff city centre, in the same way that Bristol Airport is connected to its city centre. The introduction of this service was proposed in the National Transport Plan 2010, before the Welsh Government had considered purchasing the Airport. The Welsh Government has emphasised to us that the subsidy for the bus service secures provision of transport services for the public where the market would fail to do so, and is not intended to support the Airport; indeed a successful service might reduce the Airport's car parking income. First Cymru was contracted to provide the service for an initial period of six months following a competitive tender exercise to identify the operator able to provide the specified service for the lowest subsidy. The service runs seven days a week between approximately 4am and midnight, and covers the distance from Cardiff city centre to the Airport in around 35 minutes with few stops.

3.55 The Minister commissioned an independent review of the service, which reported in January 2014[18]. The review followed criticism that the service was heavily subsidised at the same time as local bus services were being cut back because subsidies were being reduced, that the service did not benefit residents along the route and that it was poorly used.

3.56 Among other things, the review concluded that the service had been launched to a very tight timescale without sufficient market research (for example covering routes, prices and service frequency) or promotion. Around 21,000 passengers used the service in the first four months of operation, which exceeded the level expected by the operator. Overall, passenger numbers were satisfactory considering that the period covered the low season and the service had started without preparatory marketing, although many journeys had only a handful of passengers. Service quality and reliability were good. The frequency was right but there was scope to reduce the frequency to twice an hour at the start and end of the day. It was important to maintain a simple timetable and an express service, ie, keeping the number of stops to a minimum and not acting as a local passenger service.

3.57 Following the review, the Welsh Government (through the Vale of Glamorgan Council) awarded a new contract with a lower service frequency for early mornings and late evenings in winter. The existing fares and routes were retained, and specialist market research was commissioned as recommended in the report. Passenger numbers were around 98,000[19] in 2014-15, markedly higher than the levels reported in 2013-14, which has reduced the per passenger subsidy.

18 Professor Stuart Cole, **Cardiff Airport Express (T6): External Ministerial Review**, Welsh Government, 2014

19 Based on passenger numbers measured by on-board tracking systems. The service operator's electronic ticketing data may give different results.

3.58 There has been no further movement on trunking Five Mile Lane to create a fast route to Junction 34 of the M4 although funding is now available for safety improvements to the route, and work is expected to begin in the near future (paragraph 1.11c). However, the Welsh Government has improved access from the M4 to the Cardiff Southern Distributor Road (A4232) at Junction 33 which will have the benefit of quickening journey times for passengers travelling by car via Junction 33.

3.59 The shuttle bus service between Rhoose Cardiff International Airport railway station and the Airport remains in place and meets every train arriving at the station to take passengers to Cardiff Airport. There is currently one train an hour in each direction, and the rail service accounts for only about three per cent of passenger numbers. The Welsh Government's National Transport Finance Plan (July 2015) states that a more frequent service will be introduced after a major re-signalling project is completed in 2016, but there is no commitment to a specific date at present. The shuttle bus service is subsidised, costing around £135,000[20] in 2014-15 or about £4.50 per passenger. It is not clear that both the shuttle bus and express bus services are needed to ensure that the Airport is well connected to the public transport network and the Vale of Glamorgan Council is reviewing whether a shuttle service could be incorporated into the local bus service network with no reduction in service frequency but with financial savings.

Tourism and marketing

3.60 The Welsh Government had already established a marketing group in June 2012 to improve the coordination of marketing activity and develop opportunities for inbound tourism. The group, chaired by the Managing Director of Visit Wales, brought together Welsh Government staff involved in tourism promotion, branding and public relations with CIAL managers responsible for marketing, route development and customer service. The group continued to meet after acquisition until February 2014, when the Welsh Government decided to discontinue regular meetings and liaise on an ad hoc basis as required. The group enabled joint working between the Welsh Government and CIAL on a range of practical measures that contributed to both parties' objectives, which included:

a Visit Wales establishing a working relationship with Vueling, a low-cost Spanish airline, to promote inbound tourism to Wales from Barcelona;

b the development of visitor information hubs to provide information for visitors at key points in the terminal building;

c the design and implementation of marketing installations (paragraph 1.22); and

d joint attendance at the World Routes Summit (paragraph 3.37).

20 The Vale of Glamorgan Council pays for a contribution of £15,000 and the remainder of the subsidy is funded by the Welsh Government.

3.61 The group also served to ensure that the Welsh Government and CIAL were fully informed of each other's plans and priorities on a timely basis. However, the scope for joint marketing campaigns (for example, to promote inbound tourism on routes that CIAL wishes to support) was limited by the different priorities of Visit Wales and CIAL. The Airport's priority was to support existing routes and then to attract a major low-cost carrier, which would be interested mainly in outbound tourism to key leisure markets, while Visit Wales was focusing on the priority markets identified in the Welsh Government tourism strategy (the UK, USA and Germany). Budget pressures mean that Visit Wales has limited resources to support non-priority campaigns and is unable to fund wider route development incentives for CIAL.

St Athan

3.62 The acquisition business plan envisaged that CIAL would make significant savings by providing joint airfield management services for the St Athan airfield when it came under full civilian control (it currently operates under a military aviation regime as an RAF base). St Athan is only five miles from Cardiff Airport and it would be possible to combine air traffic control, fire and rescue, lighting, ground engineering and bird control services for both sites. However, the acquisition business plan did not include any savings in its financial projections because further work was needed to assess the potential and likely timing of any savings. CIAL's 2013 business plan did include savings of £500,000 a year from 2015-16, rising to £1.0 million a year in 2016-17 and £1.5 million a year thereafter.

3.63 The Welsh Government established, in February 2014, a task group with representatives from CIAL to plan and deliver the savings. However, the group has been unable to deliver the savings in the timescale originally expected by CIAL. It is unlikely that significant efficiency savings can be made until 2017-18 at the earliest, when the St Athan airfield is likely to come under a civilian rather than a military aviation regime, and until the existing provider of airfield services is willing to procure relevant services from CIAL. This contract does not end until November 2018, but earlier termination by agreement is possible.

3.64 CIAL's 2014 and 2015 business plans did not include any efficiency savings from joint working with St Athan. However, CIAL has increased its income from St Athan's use of air traffic services provided by CIAL following a contract renewal.

The Airport has taken measures to improve its environmental performance and to promote equality, but wider benefits will only accrue over time as the Airport grows

Environmental performance

3.65 Following its acquisition by the Welsh Government, CIAL appointed a Head of Environmental Services (a new position) to strengthen the company's environmental performance and ensure that shortcomings identified in the environmental due diligence report (paragraph 2.62) were addressed. Environmental matters did not feature much in the acquisition business plan or CIAL's 2013 business plan, but the 2014 and 2015 business plans contained significant commitments on environmental performance and the company has been very active in developing good practice in this field.

3.66 CIAL has overhauled its environmental management system and a revised version came into force in March 2015. The system includes a full hazardous waste process and a new secure compound for handling hazardous waste. At the request of Natural Resources Wales, CIAL conducted a major drainage survey of the Airport site in 2014 which found that the overall condition was good, but identified two discharges that were not covered by existing permits. CIAL has recently completed a groundwater risk assessment to support its application for a single permit to cover all discharges at the Airport site, and expects to receive the permit shortly. Quarterly testing has shown no water contamination. In August 2015, CIAL announced that an audit of the environmental management system had confirmed the achievement of phase two of the six phases of the UK-recognised Seren Scheme accreditation. In November 2015, the Airport won the Airport Operators' Association award for 'best environmental initiative' in 2015 for its measures to reduce waste, abate aircraft noise and cut CO_2 emissions through more efficient energy use and aircraft landing practices.

3.67 CIAL is pursuing several projects to reduce its environmental impact and, where possible, to provide revenue or savings for the company. These initiatives fall into four themes:

a **Energy efficiency**: CIAL is developing a comprehensive energy policy and implementing energy-saving initiatives with the help of consultants funded by the Carbon Trust Wales. Key elements of this work include an ongoing programme to replace conventional lighting with LED bulbs, and installation of a new heating and air conditioning system during 2015. CIAL expects these initiatives to save around £480,000 a year in energy costs and to reduce CO_2 emissions by 901 tonnes a year.

b **Waste management**: The 2014 business plan included a commitment for CIAL to adopt best practice in waste management and to become certified as a 100 per cent landfill divert site (ie, none of the waste produced at the Airport would go to landfill). The Airport installed a composting facility (known as a 'food rocket') to handle all food waste produced at the Airport and with capacity to take food waste from nearby hotels and other businesses to generate revenue. The food rocket enabled the Airport to become a 100 per cent landfill divert site by March 2015, with about 90 per cent of waste recycled and the remainder incinerated.

c **Wind farm mitigation measures**: Until recently, the Airport had to object for safety reasons to all applications to develop wind farms within the line of sight of the airport radar. However, emerging technologies mean that the Airport is now able to mitigate the effect of wind turbines on the radar and can therefore accept some of these applications. CIAL can also charge developers for implementing the mitigation technology, providing an additional source of revenue. The Airport signed the first contract with a developer in April 2014 and expects considerable interest from other developers. CIAL is working with NATS (air traffic control services) to examine emerging windfarm mitigation technologies to ensure that, in future, it is able to respond positively to development applications to the fullest possible extent. CIAL has considered the potential for building wind turbines on the airport site itself, but safety concerns mean that this is not currently feasible.

d **Solar energy**: The Airport is developing proposals for a 1 megawatt array of solar panels installed on canopies over a part of the Airport's car park site. The capital cost would be borne by the developer, with reduced cost power supplied to CIAL at preferential prices. Progress with the project is dependent on the UK Government's decisions regarding feed-in tariffs.

3.68 The business case for the acquisition of the Airport identified only one significant environmental benefit from Welsh Government ownership: by increasing the proportion of local residents using Cardiff Airport, carbon emissions from transport to and from airports further afield would be reduced. Given that passenger numbers had not significantly increased at the time this report was written, it is unlikely that any significant progress has been made in this area. However, the establishment of the T9 bus service has raised the percentage of passengers arriving at the Airport by public transport, which is likely to have had a beneficial impact on carbon emissions.

3.69 Any significant increase in passenger numbers will result in an increase in CO_2 emissions attributable to flights from the Airport. There might be an offsetting reduction in CO_2 emission from flights at other airports, but the extent of this effect has not been estimated. The planned increase in route development funding by CIAL might well result in a net increase in air travel across the UK, with a consequent detrimental impact on the environment – air travel is highly polluting in terms of carbon emissions, although less so in terms of other air pollutants.

Equality

3.70 The Welsh Government conducted an equality impact assessment of the Airport in 2014. The assessment, undertaken by the Equality Support Unit in the Department for the Economy, Science and Transport, involved a review of published good practice and on-site research by two groups of people that were considered likely to face particular difficulties at the Airport – disabled people with physical impairments and transgender people. The on-site research was intended to test how well the Airport catered for the two groups by taking them through the Airport's check-in, security and boarding procedures as mystery shoppers.

3.71 The group with physical impairments reported that Cardiff's PRM (persons with reduced mobility) service was good but that distances to the outermost departure gates were a particular challenge that needed to be made clear to customers when they arrived. The assessment recommended installing toilet facilities at the Airport for those with high-level support needs[21] and this has been completed. The assessment also recommended several other practical measures, including: making fire alarm beacons more prominent; better contrast in colour schemes, for example on lifts and rails; installing a tactile line from the entrance to the PRM desk; varying the height of signs; more stair handrails; and installing seating with different heights.

3.72 Airport security procedures were the main concern for transgender people, due to the risk of embarrassing or indiscreet searches by security staff. Discreet searches are available but customers need to know to ask for them and security staff need to be trained to respond appropriately.

3.73 The Airport has agreed an equality action plan with the Welsh Government to carry out appropriate measures to deal with the issues identified in the assessment. Most of the measures are relatively straightforward and low-cost, but some will require capital expenditure and take longer to introduce. The Airport has also introduced equality-related measures in addition to the issues raised in the equality report, such as providing washing facilities that Muslims can use before prayer.

Wider economic impact

3.74 The Welsh Government and CIAL consider that the decision to purchase the Airport has safeguarded 1,600 jobs which may have been put at risk if the Airport had declined further. In terms of future growth, previously published research indicates that the Airport will have a positive effect on employment and GDP levels in South Wales broadly in proportion to passenger numbers, both from jobs created directly at the site and from indirect economic benefits flowing from inbound tourism. Based on this assessment, CIAL has estimated that the Flybe agreement will lead to direct creation of 50 jobs over the next five years. The Welsh Government has commissioned Public Policy Institute Wales to provide expert advice on maximising the economic impact of regional airports and a report is expected shortly.

21 The standard for such facilities is the 'Changing Places' toilet, which includes: a separate room with space for the disabled person and two carers, a hoist and a height-adjustable bench for changing.

Appendices

Appendix 1 - Audit methods
Appendix 2 - Chronology of key events 2005 to 2015
Appendix 3 - The Five Case Business Model
Appendix 4 - Due diligence, valuation and other professional services

Appendix 1 - Audit methods

This study was preceded by a detailed Wales Audit Office financial audit review of the acquisition of the Airport which concluded in autumn 2013. The primary purpose of this review was to confirm that the acquisition was correctly recorded in the Welsh Government's 2012-13 accounts.

In addition, the Welsh Government's Internal Audit Services reviewed the governance arrangements of the Welsh Government holding company (Holdco) for the Airport. We drew on the findings of this work, which were reported in March 2014, when we reviewed the Welsh Government's governance arrangements for its investment in Cardiff Airport.

We gathered evidence from a variety of sources to undertake our own fieldwork for this study, as set out below.

Interviews and meetings:

- key staff involved in the acquisition of the Airport to explore the Welsh Government's overall vision and objectives for the Airport, negotiations with TBI Holdings, the due diligence process and valuation;
- the Chairman, Chief Executive and senior managers at CIAL to discuss working relationships with the Welsh Government, the company's business plan and progress against objectives;
- members of the Welsh Government's holding company board and the board secretary, to discuss governance issues, business planning and progress against objectives;
- officials responsible for engaging with the Airport as a key economic player in South Wales, both before and after the acquisition, and for ensuring that it contributed to the relevant Welsh Government strategies;
- officials responsible for advising Welsh Government colleagues on financial management, equality and sustainable development in relation to Cardiff Airport; and
- members of the Airport Consultative Committee, which include local councillors and community representatives from the area around Cardiff Airport.

An invitation to other stakeholders to submit views in writing:

- non-executive directors of CIAL;
- staff at the Cardiff and Vale of Glamorgan councils to discuss the Airport's impact on their areas, their views on its future development and their perspective on the Welsh Government's engagement with them and the Airport over time;
- companies providing key due diligence and legal advice to the Welsh Government, to follow up any matters arising from document review and to explore generally their perspective on the Welsh Government's procurement of their advice;
- representatives of the business community (through CBI Wales and local chambers of commerce), to explore their perspective on Welsh Government ownership of the Airport;

- British Airways (in connection with the BA maintenance facility at Cardiff Airport);
- statutory regulators, in connection with their statutory responsibilities for aviation, health and safety and environmental protection; and
- officials or board members of the Aviation Enterprise Zone which encompasses the Airport and RAF St Athan, but is principally focussed on St Athan.

Document review:

- key strategies and policy documents in place at the time of acquisition that were relevant to the Airport's role;
- papers relating to the Welsh Government's airport taskforce and other substantive engagement with the Airport before it was purchased;
- ministerial briefings;
- the business cases for the investment and Treasury guidance on investment appraisal;
- professional valuations of the Airport as both a commercial asset and a public asset and related professional advice;
- notes and correspondence on the Welsh Government's negotiations with TBI Holdings/Abertis;
- due diligence reports and advice relating to the acquisition and subsequent state aid issues;
- the sale and purchase agreement with TBI Holdings, through which Abertis owned the Airport
- the Welsh Government's Management Agreement with CIAL and other formal governance documents;
- minutes and papers of the Welsh Government holding company (Holdco), which include management reports from Cardiff Airport and correspondence with CIAL board members and senior managers;
- CIAL's management accounts and other data provided to Holdco;
- CIAL's business plans and related correspondence with Holdco;
- published information about Cardiff Airport, including CIAL's annual accounts, aviation statistics, public statements by Ministers, evidence to Parliamentary and National Assembly inquiries, press releases and media coverage; and
- documents relating to the subsidised bus services to the Airport, including a published report for the Minister on the operation of the service and contractual information.

Appendix 2 - Chronology of key events 2005 to 2015

Date	Event
2005	Abertis acquire CIAL by acquiring its holding company, TBI.
2006	Cardiff Airport publishes a ‘Master Plan’ which foresees traffic growth to 4.8 million passengers per annum by 2015 and 7.8 million in 2030. Plan concludes that the impact of this growth on the local environment will be limited, but some additional infrastructure (a terminal extension, new departure gates and multi-story car parking) will be needed and transport links will need to be enhanced.
2007	Passenger numbers reach a peak of 2.1 million. The Welsh Government starts discussions on capital grant to improve infrastructure at the Airport.
October 2010	The Welsh Government submits state aid notification to the European Commission, seeking permission to award capital grant to CIAL.
May 2011	The European Commission approves the state aid proposal for a potential capital grant.
June 2011	The Welsh Government decides not to award a capital grant to CIAL as Airport owners are unwilling to commit to their share of the project cost on the timescale foreseen in the state aid notification.
July 2011	The First Minister meets the Chief Executive Officer of Abertis Airports to discuss concerns about the Airport’s performance. Following the meeting, Welsh Government officials make informal enquiries to see if Abertis is open to offers to sell the Airport. Welsh Government documents note that, at that time, Abertis indicated that it was not interested in disposing of its assets but would accept £200 million. Officials felt that the price suggested was so unrealistically high as to be a total rebuttal of the Welsh Government’s approach.
November 2011	BMIBaby ceases operations at Cardiff, causing a further decline in passenger numbers.
May 2012	The First Minister establishes the Cardiff Airport taskforce to improve working relationships and bring together stakeholders to assist the Airport’s development.
September 2012	Abertis expresses a willingness to sell the Airport and asks if the Welsh Government is willing to make an offer. Officials prepare a strategic outline business case for buying the Airport.
October 2012	The Welsh Government writes to Abertis with an indicative, opening offer of £35 million, subject to due diligence.

Date	Event
November 2012	Abertis rejects the offer but states that it would consider an offer of £56 million to £58 million, this being the lower range of Abertis' own valuation of the Airport. The Welsh Government asks to proceed to a detailed due diligence phase, after which a final price will be agreed. The Welsh Government commissions a provisional expert valuation of the Airport from KPMG, based on Abertis' projections and an 11.5 per cent to 12.5 per cent cost of capital.
December 2012	Abertis and the Welsh Government sign a process letter which sets out the process and timetable for a successful negotiation leading to acquisition of the Airport. Provisional valuation report suggests a valuation range of £25 million to £35 million, based on an 11.5 per cent to 12.5 per cent cost of capital, but with a higher valuation possible by taking a positive view of future performance. The Welsh Government makes a non-binding offer of 'up to £55 million' for the Airport, subject to due diligence. The First Minister announces intention to buy the Airport to the National Assembly.
January 2013	Due diligence work undertaken by external contractors, coordinated by a project team in the Welsh Government staffed by officials.
February 2013	Due diligence work continues and draws towards a conclusion. KPMG updates its expert valuation based on outcome of due diligence, and revises its indicative valuation range from £25 million to £35 million, to £20 million to £30 million. This is based on a 12 to 14 per cent cost of capital and the exclusion of marketing income from a commercial agreement between the Welsh Government and CIAL. The project team meets Permanent Secretary to discuss due diligence and valuation results and the approach to negotiations. Officials feel that KPMG's valuation is too low because the cost of capital is too high and it excludes the impact of the marketing income.

Date	Event
March 2013	The Welsh Government puts revised offer of £41 million to Abertis, which is rejected. The Welsh Government commissions further valuation work from Arup, which incorporates wider benefits and establishes a valuation of £472 million as a public asset. After reviewing KPMG's commercial valuation and related advice, Arup suggests an upper value limit of £55.3 million, based on a 12 per cent cost of capital and including marketing income, and a benefit-cost ratio of 8.6 relative to the public asset valuation. The Welsh Government submits a revised offer of £52.0 million to Abertis, which is accepted. All due diligence completed and the sale and purchase agreement concluded on 27 March. The Welsh Government pays £52.0 million to Abertis for all CIAL's shares and conversion of loan into equity. The Welsh Government provides £3.3 million of working capital to CIAL in stages and converts this into share capital, raising the total cost of investment to £55.3 million. The Welsh Government establishes Holdco to manage its investment at CIAL and appoints three civil servants as directors. The Minister of Economy, Science and Transport appoints Lord David Rowe-Beddoe to chair the CIAL board. The Welsh Government appoints Jon Horne as CIAL's Chief Executive.
April 2013	Four non-executive members of the CIAL board area appointed.
June 2013	CIAL submits its first post-acquisition business plan, which is rejected by Holdco. A revised plan is approved by Holdco in September 2013.
June 2013	Opening of new art and multimedia installations as part of the commercial marketing agreement between the Welsh Government and CIAL.
August 2013	The T9 Cardiff Airport Express bus service is launched on 1 August, connecting Cardiff city centre with the Airport, and subsidised by the Welsh Government.
November 2013	The Welsh Government agrees a £10 million commercial loan facility for CIAL principally to fund a major programme of capital expenditure to improve the terminal and improve access to the terminal building.
December 2013	CIAL secures Cityjet services to Paris, Glasgow and Jersey following withdrawal of services by Flybe.

Date	Event
April 2014	Holdco approves CIAL's 2014-15 business plan.
November 2014	The Welsh Government approves in principle a commercial loan facility of £13 million to fund route development incentives generally.
March 2015	CIAL signs a 10-year agreement with Flybe to base two aircraft at Cardiff and operate services to at least 10 destinations. The agreement is expected to result in a substantial net increase in passenger numbers by the end of the 10-year period.
April 2015	Holdco approves CIAL's 2015-16 business plan.

Appendix 3 - The Five Case Business Model

The Five Case Business Model was been developed by HM Treasury, the Welsh Government and the Department of Health to provide a framework for developing robust business cases that fulfilled the requirement of Treasury guidance on project appraisal and evaluation.

The essential elements of the model – the five cases – are:

The strategic case

Sets out the rationale for the proposal and makes the case for change at a strategic level.

The economic case

Demonstrates how a spending proposal optimises public value. As part of this, assesses the economic costs and benefits of the proposal to society as a whole.

The commercial case

Evaluates whether the proposal is commercially viable.

The financial case

Appraises affordability and sources of funding over the lifespan of the scheme.

The management case

Assesses whether the proposal can be delivered and sets out management responsibilities, governance and reporting arrangements.

The model suggests developing the business case in three main stages:

a **Preparing a strategic outline case:** An initial scoping stage to confirm the strategic context of the investment, make a robust case for change, and provide stakeholders and customers with an early indication of the proposed way forward. The strategic outline case should identify investment objectives, the benefits and risks of the proposed investment, any constraints and dependencies that might influence how the Government invests, and the critical success factors that the investment must achieve. The preferred option is not selected at this stage, but a shortlist of feasible options should be put forward after considering a wide range of potential options for delivering the investment.

b **Preparing the outline business case:** In this detailed planning stage, the project team should undertake detailed economic appraisals of the shortlisted options to identify the one that provides the best value for money. Benefits and risks should be thoroughly assessed and a preferred option recommended. The outline business case considers the commercial viability and affordability of the preferred option and outlines how it can be procured (if appropriate) and managed.

c **Preparing the full business case:** In this final stage, the procurement route and management arrangements are finalised and previous stages are revisited to confirm that decisions are valid, with adjustments made as necessary.

Appendix 4 - Due diligence, valuation and other professional services

The Welsh Government commissioned 12 key pieces of work from professional advisors to inform its decision to purchase the Airport, mostly formal due diligence but also expert valuation and other advice, including the preparation of an acquisition business plan.

Due diligence

Financial due diligence (KPMG)

Review of financial data, accounting policies, drivers of current and historical trading performance, assets and liabilities (especially pensions), accuracy of historical budgeting and effect of separation from TBI group (itself a subsidiary of the Abertis group). The work involved testing the management accounts presented by the Airport's owners for the due diligence process.

Technical and commercial appraisal (York Aviation)

Detailed analysis of Cardiff Airport's position in the market, passenger numbers and routes, income, operating expenditure and capital spending.

Traffic forecasts based on four scenarios from do nothing to a high-growth variant with a major low-cost carrier boosting passenger numbers

Legal due diligence (Eversheds)

Analysis of legal risks based on review of contracts, property titles, licenses and other legal documentation.

Environmental due diligence (Hyder)

Analysis of environmental risks based on document review and short site visit (no detailed testing involved). Included a comprehensive review of environmental policies and procedures and an overview of asset condition.

Insurance review (Marsh)

Review of claims, policies and likely requirements in future.

Valuation

Interim valuation (KPMG)

Valuation of the Airport as a commercial business on the basis of (a) historic earnings, and (b) expected future cash flows using Abertis' projections for the growth of the Airport. A series of updated interim valuations was prepared during the due diligence process.

Calculation of possible commercial values (KPMG)

In March 2013, KPMG was commissioned to provide the Welsh Government with an advice note outlining possible commercial values for the Airport, based on assumptions provided by the Welsh Government, for four different growth scenarios at various costs of capital.

Technical note on valuation (Arup)

Review of KPMG valuation and development of a value to the public sector, based on Treasury guidance, which included wider public benefits. Assessment of an appropriate upper limit of value based on both commercial and public sector investment appraisal methods.

Other advice

Acquisition business plan (KPMG)

The Welsh Government commissioned KPMG to prepare a business plan for the Airport based on the results of the due diligence work and forecasts prepared by York Aviation, bringing together other elements of the professional advice as appropriate.

Advice on strategic regional context (M&G Barry)

Review of the Airport's market position and recent performance. Assessment of the Airport's economic impact, its potential contribution to wider UK and Welsh Government policies and initiatives, and opportunities to improve infrastructure and transport links.

Sustainability appraisal (Arup)

High-level summary of: the sustainable development policy agenda in Wales; the contribution that airports can make generally to the sustainable development agenda; and an assessment of the potential impact of Cardiff Airport using the Welsh Transport Planning and Appraisal Guidance (WelTAG) criteria and in the context of the plans for growth set out in the acquisition business plan.

Separation and transition plan (AIE LLP)

Advice on how to manage the main short-term risks arising from the transition of CIAL from Abertis to Welsh Government ownership and how to replace services previously provided by the TBI Group. Included an outline plan for the first 100 days of Welsh Government ownership.

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