



WALES **AUDIT** OFFICE
SWYDDFA **ARCHWILIO** CYMRU

January 2014
www.wao.gov.uk

Intra-Wales – Cardiff to Anglesey – Air Service

Memorandum for the Public Accounts Committee

Report presented by the Auditor General for Wales to the National Assembly for Wales

I have prepared this report for presentation to the National Assembly under the Government of Wales Act 2006.

The Wales Audit Office team who assisted me in preparing this report comprised Jeremy Morgan and Matthew Mortlock under the direction of Gillian Body.

**Huw Vaughan Thomas
Auditor General for Wales
Wales Audit Office
24 Cathedral Road
Cardiff
CF11 9LJ**

The Auditor General is totally independent of the National Assembly and Welsh Government. He examines and certifies the accounts of the Welsh Government and its sponsored and related public bodies, including NHS bodies in Wales. He also has the statutory power to report to the National Assembly on the economy, efficiency and effectiveness with which those organisations have used, and may improve the use of, their resources in discharging their functions.

The Auditor General also appoints auditors to local government bodies in Wales, conducts and promotes value for money studies in the local government sector and inspects for compliance with best value requirements under the Wales Programme for Improvement. However, in order to protect the constitutional position of local government, he does not report to the National Assembly specifically on such local government work, except where required to do so by statute.

The Auditor General and his staff together comprise the Wales Audit Office. For further information about the Wales Audit Office please write to the Auditor General at the address above, telephone 029 2032 0500, email: info@wao.gov.uk, or see web site www.wao.gov.uk

© Auditor General for Wales 2014

You may re-use this publication (not including logos) free of charge in any format or medium. You must re-use it accurately and not in a misleading context. The material must be acknowledged as Auditor General for Wales copyright and you must give the title of this publication. Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned before re-use.

Contents

Introduction	4
Origins of the Air Service	7
Procurement and contracting	9
Commencement of the original three-year Air Service contract in May 2007	9
Unsuccessful re-tendering of the contract in early 2010	9
Interim contractual arrangements for the period from May to December 2010	11
Procurement of the current January 2011 to December 2014 contract	12
Appointment of a replacement air carrier in November 2012	13
Costs: 2007-08 to 2012-13	16
Performance monitoring: punctuality, load factor and passenger numbers	17
Benefits evaluation	20
Looking to the future	21
Appendix 1 – Timeline of key events	23

Introduction

- 1 In March 2013, the Chair of the Public Accounts Committee passed on to the Auditor General correspondence from Byron Davies AM which raised concerns about a number of air transport related issues, including the Welsh Government's subsidy of the 'Intra Wales – Anglesey Airport (RAF Valley) to Cardiff Airport – Air Service' (the Air Service). The Committee discussed the correspondence at its meeting on 7 May 2013 and took up the Auditor General's offer of a briefing paper in respect of the subsidy. The Committee also passed on to the Wales Audit Office certain specific concerns about previous procurement arrangements for the Air Service.
- 2 The Air Service, and the Welsh Government's subsidy of it, first started on 7 May 2007. The Welsh Government subsidy is provided under terms known as a 'Public Service Obligation' (Box 1).
- 3 While there have been various changes over time (Appendix 1), the Air Service is currently operated by two companies. Citywing provides the ticketing and marketing functions and Links Air operates the flights, having taken over this function from FLM Aviation in November 2012². The current contractual agreement expires on 9 December 2014. Other parties involved in the delivery of the Air Service include the Ministry of Defence, which owns RAF Valley, Cardiff Airport and a separate contractor (Europa) that operates the terminal building at RAF Valley on behalf of the Isle of Anglesey County Council (Figure 1).
- 4 In addition to its direct subsidy of the Air Service, currently worth up to £1.2 million a year, the Welsh Government currently provides up to £300,000 in grant funding each year to the Isle of Anglesey County Council. This grant funding covers the costs incurred in running the terminal building at RAF Valley, including the operating contract with Europa, the Council's expenses for administration and contract management, and the lease and landing fees paid to RAF Valley. The Wales Audit Office has certified this grant since it commenced in May 2007 and has found no issues of concern.

Box 1 – Public Service Obligation (PSO)

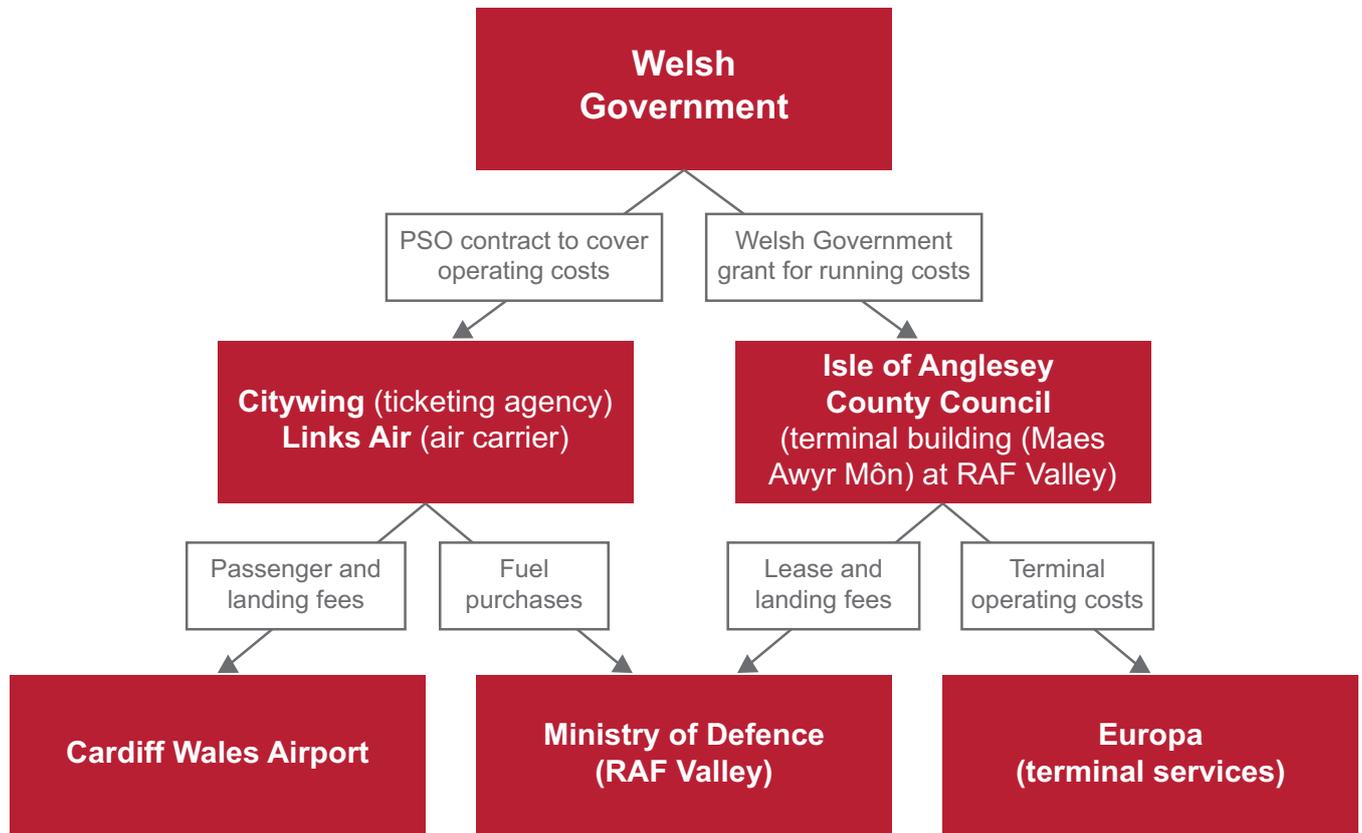
EU member states may provide scheduled air services through PSOs on air routes which are deemed vital for the economic development of the region they serve but which are not commercially viable in their own right. Member states must respect the conditions and the requirements set out in Article 16 of the European Commission's Air Services Regulation 1008/2008¹. For example, the regulations state that the airports used for the service should be linked to one another and to the city or conurbation they serve by frequent, reliable and efficient public transport services.

The PSO is a subsidy to compensate the operator for the deficit incurred in providing a service which would not otherwise be commercially viable.

1 REGULATION (EC) No 1008/2008 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, of 24 September 2008 on common rules for the operation of air services in the Community. When the Welsh Government was planning and procuring the original Air Service contract the relevant equivalent regulation was Regulation No 2408/92, of 23 July 1992 on access for Community air carriers to intra-Community air routes. There are differences between the 1992 and 2008 regulations. For example, the 1992 regulations did not contain the requirement cited in Box 1 in relation to public transport connections.

2 FLM are still party to the contract and as such, remain jointly and severally liable along with Citywing and Links Air.

Figure 1 – Intra-Wales Air Service organisation chart



Note

We understand that, since the start of the Air Service in 2007, landing fees at RAF Valley have been paid via the grant given to the Isle of Anglesey County Council by the Welsh Government. This is in contrast to the landing fees at Cardiff Airport that have been paid by the PSO contractors. We understand that because the landing fees at RAF Valley are paid by one public body to another, this reduces their cost and that this arrangement is therefore more cost-effective to the Welsh Government than if paid by the PSO contractors but recharged to the Welsh Government through the subsidy arrangement.

Source: Wales Audit Office

- 5** As has been the case since May 2007, the Air Service currently provides two scheduled flights in both directions between Anglesey and Cardiff each weekday. The timing of the flights into and out of Anglesey is constrained by the times when RAF Valley is open – from 08:00 to 18:00 Monday to Thursday and 08:00 to 17:00 on Friday. However, the schedule is intended to enable users of the service to maximise their time at either end of the route without the need for an overnight stay, as follows:
- a** Cardiff to Anglesey: 07:40 – 08:40
 - b** Anglesey to Cardiff: 09:00 – 10:00
 - c** Cardiff to Anglesey: 16:15 – 17:20 (15:15 – 16:20 on Fridays)
 - d** Anglesey to Cardiff: 17:40 – 18:45 (16:40 – 17:45 on Fridays)
- 6** The schedule is planned so that a single aircraft, carrying 18 passengers, undertakes all of the flights each day, offering the potential for up to 18,720 seats per year. Currently, the maximum single fare under the terms of the PSO contract is £59.45, with lower fares available for advance bookings. The advertised maximum fare has increased from £52 compared with when flights under the current contract started in January 2011. As well as factoring in inflation, the increase is because the advertised fare now includes certain fees that were previously charged to passengers separately from the ticket price.
- 7** Our methods in preparing this briefing paper were as follows:
- a** We reviewed a range of documentation supplied by the Welsh Government, dating back to before the commencement of the Air Service in May 2007 and including monitoring reports, procurement-related information, relevant Ministerial submissions and Welsh Government legal advice. Due to the period of time covered, it has not been easy to locate all of this information, some of which has been retrieved from archived records. We note within this paper certain issues that we have been unable to confirm from documentary evidence. However, we are satisfied that we have seen enough documentation with which to describe key developments over the lifetime of the Air Service.
 - b** We interviewed the Welsh Government's Air Service contract managers, although the official responsible for managing the contract over much of its lifetime is no longer employed by the Welsh Government.
 - c** We also interviewed representatives of Citywing, Links Air, Cardiff Airport, the Isle of Anglesey County Council and RAF Valley. We also met Martin Evans, an aviation industry expert at the University of South Wales (previously with the University of Glamorgan), who provided advice to the Welsh Government on the procurement of the Air Service in November 2012.
 - d** We compared Air Service performance data with industry-wide figures.

Origins of the Air Service

- 8** In December 2003, a UK government air transport white paper³ identified the potential for new intra-Wales air services, particularly in respect of connecting North and South Wales. In July 2004, the Welsh Government undertook a scoping study to investigate this potential more fully, followed by consultation with stakeholders on issues such as the potential route, environmental impacts and economic considerations.
- 9** The original concept was to enable people to travel between North and South Wales in one day, to allow time for business or leisure activities and to facilitate connecting flights out of Cardiff Airport. The Welsh Government's option appraisal, in December 2004, included the prospect of connecting flights between Cardiff and West Wales.
- 10** The Welsh Government identified three possible locations in North Wales: RAF Valley, Caernarfon and Hawarden (the Airbus site). While part of the option appraisal, the Welsh Government may have found it difficult to justify a PSO subsidy for the Hawarden route for a number of reasons; including Hawarden airport's proximity to other transport links from North to South Wales. The PSO regulations state that 'the necessity and the adequacy of an envisaged PSO shall be assessed by the Member State having regard to the possibility of having recourse to other modes of transport

and the ability of such modes to meet the transport needs under consideration, in particular when existing rail services serve the envisaged route with a travel time of less than three hours and with sufficient frequencies, connections and suitable timings'.
- 11** The Welsh Government's Economic Advice Division undertook a cost-benefit analysis for each of the following route options:

 - a** Swansea – Cardiff – RAF Valley
 - b** Swansea – Cardiff – Caernarfon
 - c** Swansea – Cardiff – Hawarden
- 12** In addition to the costs of operating the different services, the cost-benefit analysis factored in estimated capital costs to develop facilities at each of the North Wales locations – £390,000 for RAF Valley, £905,000 for Caernarfon, and £450,000 for Hawarden. We note that, in the end, the Welsh Government invested £1.5 million developing a brand new terminal building at RAF Valley, rather than upgrading existing facilities. However, we have not seen sufficient evidence with which to compare the basis of the initial estimate with the work that was undertaken to develop RAF Valley. It is possible that the estimates for the other sites would also, in practice, have proven less than necessary.

³ Department for Transport, *The Future of Air Transport – White Paper and the Civil Aviation Bill*, December 2003

- 13** The cost-benefit analysis identified that each of the three short-listed routes would continue to need public subsidy throughout the 30-year appraisal period. However, there was a negative net present value associated with each route over the 30-year period, using the HM Treasury recommended discount rate of 3.5 per cent⁴.
- 14** At -£5.5 million, the least negative net present value of the costs and benefits was for the 'Swansea – Cardiff – RAF Valley' route. This compared with -£9.0 million for the 'Swansea – Cardiff – Hawarden' route and -£9.3 million for the 'Swansea – Cardiff – Caernarfon' route. RAF Valley had also been the more popular route based on responses to the Welsh Government's initial stakeholder consultation although, as noted previously (paragraph 5), its opening times present limitations on the operation of the service.
- 15** Regardless of the route, the cost-benefit analysis identified that there may be some wider economic benefits in the form of business investment and benefits to the tourism industry. However, the Welsh Government did not expect net impacts to be large. For example, employment generation directly associated with the service was not expected to exceed between 20 and 50 jobs. While there did not appear to be an economic case for establishing a service, based on the results of the cost-benefit analysis, the Welsh Government's business case contended that the unquantifiable benefits that may be gained through enhancing the feeling of integration between North and South Wales represented sufficient justification for introducing the service.
- 16** Based on the work we have undertaken and the information supplied by the Welsh Government, we have been unable to confirm the basis of the Welsh Government's eventual decision to drop the Swansea connection from its plans for the Air Service. Nor have we seen evidence of the Welsh Government having revisited its cost-benefit analysis to take into account the removal of the Swansea connection from any of the options that it considered.

⁴ The discount rate is used to convert all costs and benefits to 'present values', so that they can be compared. The recommended discount rate is 3.5 per cent. Calculating the present value of costs and benefits provides the net present value (NPV) of an option. The NPV is the primary criterion for deciding whether government action can be justified. Generally, where the NPV is negative, the option is rejected. However, in this case all the options were negative. The Welsh Government identified that its calculations could have been significantly affected by altering one or more of the underlying assumptions but that the calculations were based on the best available information. A number of factors were said to be unquantifiable, such as security, environment accessibility and integration and some of the wider economic benefits.

Procurement and contracting

Commencement of the original three-year Air Service contract in May 2007

17 In February 2007, following the evaluation of three competing bids, the Welsh Government awarded the original three-year PSO air carrier contract to Highland Airways. Services started on 7 May 2007. Under the terms of that contract, the Welsh Government paid a subsidy of up to £800,000 per year for three years. However, additional payments of up to £100,000 per year could be made – subject to agreement between the Welsh Government and Highland Airways – if there were significant increases in air fuel prices. The contract specified several important criteria for the route, including a maximum single fare of £50 and various minimum service levels.

Unsuccessful re-tendering of the contract in early 2010

18 In mid-2009, ahead of the expiry of the first Air Service contract in May 2010, the Welsh Government started to explore the merits of retendering the contract on the back of the apparent popularity of the service over the previous two years. Welsh Government officials examined various options, including the possibility of increasing the size of the aircraft to a 29 or 49-seater, increasing the frequency of flights and possible changes to maximum fares. While the Welsh Government commissioned a financial appraisal from an

external multidisciplinary consultancy firm to support its consideration of future options, it did not carry out a cost-benefit analysis as part of that appraisal.

19 In November 2009, the Welsh Government commenced the OJEU⁵ tendering process for a new Air Service contract based on a service using an aircraft offering at least 29 and as many as 50 seats. However, the records that we have reviewed indicate that, during the procurement process, the Welsh Government decided against increasing the size of the aircraft from 18 seats for two reasons:

- a** Increasing the size of the aircraft would have incurred air passenger duty⁶ at £11 per passenger per flight and would have significantly increased the cost of ticket price and/or the PSO subsidy – although the impact of the duty had been identified in the financial appraisal that preceded the start of the procurement process. Many PSO funded routes serving destinations in Scotland use larger aircraft and are exempt from the duty, but the population density of Anglesey is too large for an exemption because it has more than 12.5 people per square kilometre⁷.
- b** The Welsh Government could not guarantee sufficient growth in passenger numbers.

⁵ The Official Journal of the European Union is the gazette of record for the European Union. It includes invitations to tender, prior information notices, qualification systems and contract award notices.

⁶ Air passenger duty is an excise duty charged on the carriage of passengers flying from a United Kingdom airport on an aircraft that has an authorised take-off weight of more than 10 tonnes or more than 20 seats for passengers.

⁷ The specific areas that this exemption applies to are stipulated in the *Air Passenger Duty (Designated Region of the United Kingdom) Order SI 2001/808*, which came into force on 1 April 2001.

- 20** The Welsh Government officials now responsible for managing the Air Service contract have suggested to us that another reason for not increasing the size of the aircraft would have been that the airport at RAF Valley does not meet the requirements of the UK National Aviation Security Programme for civilian aircraft with more than 18 seats. Among these requirements is the need to establish a restricted zone which we understand would represent a significant logistical challenge, and additional costs, due to the airport being located within an operational RAF airfield.
- 21** It is not clear whether the Welsh Government was fully sighted of the security programme requirements when tendering for the Air Service contract and when commissioning external consultancy advice:
- a** We have not seen any specific reference to the security programme requirements in respect of RAF Valley in the procurement records we have reviewed for the re-tendering of the Air Service contract in November 2009 or for the original contract in 2007. One of the tenders for the original contract included a bid for using a 50-seat plane, which the Welsh Government deemed a compliant bid.
 - b** We found that, despite considering the possibility of increasing the size of the aircraft to a 29 or 49-seater, the consultancy report that the Welsh Government commissioned in 2009 ([paragraph 18](#)) did not consider issues relating to the security programme requirements.
- 22** In March 2010, the Welsh Government published its National Transport Plan with the commitment that, in letting a new contract to cover the period up to 2014, it would increase the capacity of the Air Service. The decision to remain with an 18-seat aircraft ruled out one of the main methods for fulfilling this commitment.
- 23** Six companies originally expressed an interest in the contract, but five of those companies pulled out after the Welsh Government decided against increasing the size of the aircraft from 18 seats. Only one company, the incumbent contractor Highland Airways, bid for the contract. However, for reasons that we have been unable to ascertain from the documentation now held by the Welsh Government, the bid from Highland Airways was based on operating a 30-seat aircraft, despite the Welsh Government having changed its tender specification.
- 24** In the event, however, the Welsh Government rejected the bid it received from Highland Airways amidst concerns about the financial standing of the company, including that the company's 2008-09 accounts were unaudited and had not been filed with Companies House. Highland Airways complained to the Welsh Government about aspects of the procurement process, including that the Welsh Government had not identified its concerns about the company's financial standing at the expression of interest stage. Highland Airways then ceased operating on 24 March 2010 and the Air Service came to an abrupt halt.

Interim contractual arrangements for the period from May to December 2010

25 In light of its rejection of the only bid that it had received, the Welsh Government examined the merits of an interim contract for the continuation of the Air Service until the end of the December 2010. In raising concerns about the Welsh Government's original procurement process, Highland Airways also expressed disappointment that the Welsh Government had issued a press release about a new short-term contract being tendered before giving Highland Airways the opportunity to appeal against the rejection of its bid for the planned longer-term contract. Highland Airways tried to persuade the Welsh Government to agree a contract extension. However, coupled with its concerns about the company's financial standing, the Welsh Government received legal advice that a contract extension would have breached EU procurement regulations.

26 The PSO regulations state that member states can make interim arrangements for continuation of a service for up to seven months 'in case of emergency'⁸. The European Commission does not clearly define what constitutes an emergency, but Welsh Government legal advice stated: 'there must be more than just an interruption of the service there must be an emergency as well. We are not aware of any specific guidance from the European Commission on this provision but there is a similar provision in the Public Contracts Directive referring to extreme urgency brought about by events unforeseeable by the contracting authority. However, the legal advice also noted that the PSO regulations say that: 'in case of sudden interruption of service by the Community air carrier selected in accordance with Article 17 [public tender procedures], the Member State

concerned may, in case of emergency, select by mutual agreement a different Community air carrier to operate the PSO for a period up to seven months under the following conditions:

- a** any compensation paid by the Member State shall be made in compliance with the PSO regulations;
 - b** the selection shall be made among Community air carriers in compliance with the principles of transparency and non-discrimination; and
 - c** a new call for tender shall be launched.'
- 27** The Welsh Government's legal advice questioned whether the 'emergency' condition could be satisfied. The advice stated: 'if you want to keep the service going pending a new procurement exercise and award of contract, we cannot identify any risk free options for doing so' and 'there are likely to be risks involved which may lead to the interim contract being terminated and may require payment by the Welsh Government of damages and possibly fines'. The advice also stated that any communication with the European Commission to, for example, inform it of any proposed action, did not remove the risk of legal challenge from a potential carrier.
- 28** The PSO regulations state that 'the Commission... shall be informed without delay of the emergency procedures and of its reasons' and, on 10 March 2010, the Welsh Government wrote to the European Commission to set out the issues it was facing. A reply came from the European Commission in the form of a telephone conversation. The Welsh Government's note of that conversation highlights that, amongst other things, the European Commission would have been more cautious if it were

⁸ Article 16/12 of REGULATION (EC) No 1008/2008 on common rules for the operation of air services in the Community.

providing written advice; the full procurement should be done as soon as possible; and the European Commission should be kept up-to-date. However, we have not seen any further records of contact between the European Commission and the Welsh Government with regard to the interim contract arrangement.

29 Following the telephone conversation with the European Commission, the Welsh Government accepted the risks identified by its legal advice and, on 31 March 2010, began an interim tender process with a deadline for tenders on 9 April 2010. The Welsh Government received seven bids but deemed that three of these bids did not comply with its tender requirements. On 20 April 2010, officials made a recommendation to the then Minister for Economy and Transport (Ieuan Wyn Jones) that an interim contract should be awarded to Manx2⁹, a 'virtual commuter airline'¹⁰, with its partner airline FLM (a German airline).

30 Following the award of the interim contract, the Welsh Government received correspondence from an airline that had not bid for the contract, stating that the PSO carrier must hold a valid air operator's certificate¹¹ and that, as Manx2 was only a virtual airline, the contract was illegal. The Welsh Government made it clear that the Manx2/FLM bid was a consortium bid and that both Manx2 and FLM would be joint signatories. The Welsh Government's legal advice also stated that this was a legal course of action to take. The Welsh Government was under no obligation to have stated in its tender documentation that this contractual arrangement was acceptable. We understand that it was not until it was put forward by Manx2/FLM that the Welsh Government gave this sort of contractual arrangement any consideration.

31 On 27 April 2010, RAF Valley and the Isle of Anglesey County Council wrote to the Welsh Government emphasising their concerns over the running of the interim contract procurement process. Both organisations stated that they had received little contact from the Welsh Government during the process. RAF Valley emphasised that the prime objective of RAF Valley is for the training of RAF aircrew and that 'nothing should be done to jeopardise this', reminding the Welsh Government that there might be issues to resolve, for example with regard to consideration of an operator's safety record, before they could be permitted to operate into RAF Valley. Representatives of RAF Valley and the Isle of Anglesey County Council told us that the Welsh Government engaged with them much better in the subsequent tender for the full contract.

Procurement of the current January 2011 to December 2014 contract

32 On 9 July 2010, the Welsh Government set in motion the process for the procurement of a full four-year contract. The OJEU tender assumed increased costs of up to £1.2 million per year for the continuation of the same service specification. This above-inflation increase in the contract value, compared to £800,000 under the previous contract, was due mainly to higher landing fees at Cardiff Airport and increased fuel costs. The Welsh Government's tender documentation also invited potential bidders to include a bid for a third rotation on Mondays and Fridays, the days of highest demand, offering an opportunity to fulfil the National Transport Plan commitment to increase the capacity of the Air Service.

⁹ Following a management buy-out in December 2012, Manx2.com became CityWing on 1 January 2013.

¹⁰ A virtual airline is an airline that has outsourced as many possible operational and business functions as it can, but still maintains effective control of its core business.

¹¹ An air operator's certificate is the approval granted from a national aviation authority to an aircraft operator to allow it to use aircraft for commercial purposes.

33 While seven companies expressed an interest in the contract, Manx2 and FLM were alone in submitting a formal [joint] bid and did not include the third rotation as part of its bid. In addition, legal advice obtained by the Welsh Government during the course of the procurement process stated that the third rotation would breach the PSO regulations because it must be for the minimum necessary service only.

34 Because Manx2 and FLM were alone in bidding for the contract, the Welsh Government referred the bid to its Corporate Procurement Service for 'departure approval'¹². The submission from transport officials to the Welsh Government's Corporate Procurement Service included an evaluation of the bid by an external aviation consultancy. The evaluation advised that the bid represented value for money.

35 The bid from Manx2 was on the basis of sub-contracting the flying services to FLM. However, the Welsh Government's legal advice stated that to comply with the PSO regulations, Manx2 and FLM, should be joint signatories to the contract, thus reducing the risk of any legal challenge in regard to the contractor not holding an air operator's certificate. Legal advice stated that regulations do not explicitly prohibit the joint-signatory approach and there did not appear to be any infringement of EU law. Furthermore, the Welsh Government had previously informed the European Commission that it had awarded the temporary contract on the same basis and the European Commission did not question it. The Welsh Government also considered that the risk of legal challenge from competitors was low. On 23 November 2010, Welsh Government officials recommended to the

then Minister for Economy and Transport (Ieuan Wyn Jones) the appointment of Manx2 and FLM. Flights under the new four-year contract commenced on 4 January 2011.

Appointment of a replacement air carrier in November 2012

36 On 1 November 2012, the German Aviation Authority regulator removed its accreditation from FLM as a licensed air carrier because FLM failed to meet a financial assets target set. Consequently, from 1 November 2012, FLM no longer held a valid air operator's certificate and therefore was no longer eligible to operate the Air Service.

37 The Air Service contract specifies that the service providers should maintain planned arrangements for one back-up aircraft to ensure continuity of the service. Any provider brought in on a temporary basis must hold an air operator's certificate and comply with relevant clauses of the contract regarding the operation of the service. On 1 November 2012, Manx2 informed the Welsh Government that FLM was unable to operate the service from that day and that Manx2 had arranged a back-up supplier (Links Air) to operate the service whilst FLM attempted to regain its air operator's certificate and resume its role, a process in which it ultimately was unsuccessful. There was no interruption in service as a result of the change of air carrier.

38 The Welsh Government invoked the PSO emergency procedure and formally assigned Links Air to the Air Service contract from 16 November 2012. The Welsh Government could have interpreted FLM's loss of accreditation as a breach of the Air Service contract, sufficient to justify a termination of the agreement. However, the Welsh

¹² The Welsh Government classifies single tenders as departures from normal contract procedures. A single tender action valued above £5,000 can only proceed by approval from the Welsh Government's Head of Corporate Governance Unit, who will seek advice from the Corporate Procurement Services.

Government determined that terminating the agreement would have 'caused severe disruption to travellers, many of whom had already booked flights and have a severe impact on a strategically important route'.

39 In accordance with the PSO regulations, the Welsh Government should have gone back out to tender to cover the remainder of the period of the existing Air Service contract to December 2014, following expiry of the seven-month emergency period on 17 June 2013. However, written advice from Martin Evans on 6 November 2012 had stated that competition among UK operators for continuation of the service on the same scale was likely only to generate a response from the incumbent operator. In addition, the advice suggested that, unless linking up with a company like Manx 2 with ticketing and marketing expertise, an EU-based operator would face high UK set-up costs.

40 Alongside its previous experience of there being only one bidder for the full contract in late 2010, the Welsh Government interpreted this advice as saying that re-tendering for the remaining contract term would not represent value for money. The Welsh Government was also concerned that a failed competition could risk serious disruption to passengers. On 7 March 2013, the then Minister for Local Government and Communities (Carl Sargeant), whose portfolio included responsibility for transport policy, agreed to assign Links Air to the contract for the remaining period of the contract, from 17 June 2013, to follow on from the seven-month emergency procedure arrangement.

41 The Welsh Government should have informed the European Commission without delay of the emergency procedure arrangements that were established in November 2012. However, it was not until March 2013, when writing to the European Commission about its decision to assign Links Air for the remainder of the existing Air Service contract from 17 June 2013, that the Welsh Government notified the European Commission of the emergency procedure. Welsh Government officials told us that the delay in writing to the European Commission about the emergency procedure was due to the following two factors in turn:

- a** Immediately after the assignment of Links Air to the PSO contract, Manx2 informed the Welsh Government of its intention to transfer its rights and liabilities to a new company called Citywing and requested that Welsh Ministers consider novating their responsibilities under the PSO contract to Citywing. Before writing to the European Commission, Welsh Government officials were waiting for legal advice and Ministerial approval on the novation of the contract to Citywing. The then Minister for Local Government and Communities (Carl Sargeant) gave his approval on 23 January 2013. Had the Minister declined the novation, we understand that this would, in effect, have terminated the PSO contract.
- b** Officials were also then waiting on the results of an investigation prompted by the Minister, on whether there was potential for the Air Service to include Hawarden as a stop in the daily rotation. In the end, this option was rejected on the basis of legal advice which stated that this would not be possible within the terms of the Air Service contract.

- 42** The Welsh Government's letter to the European Commission stated: 'this decision is being taken in the light of independent expert advice about the current state of the market in respect of low-capacity flights'. Martin Evans emphasised to us that his advice said that the market was very limited, but that he had given no opinion on the value of testing the market¹³.
- 43** The Welsh Government's direct award of the contract to Manx2/Citywing and Links Air was not in line with the PSO regulations, as it did not allow for competition. We understand from Welsh Government officials that the European Commission contacted the Welsh Government by telephone to confirm the content of the Welsh Government's letter of March 2013. We have not seen a record of that conversation but Welsh Government officials told us that the European Commission advised that it would not be responding formally and would not investigate the Welsh Government's approach further unless it received a complaint from another air carrier. There has been no further contact between the Welsh Government and the European Commission on this matter.

¹³ This correspondence was subject to a Freedom of Information request in April 2013, asking for a copy of the Welsh Government's letter to the European Commission on proposals regarding procurement of the Air Service: www.wales.gov.uk/about/foi/responses/dl2013/aprjun/transport1/dlra136/?lang=en

Costs: 2007-08 to 2012-13

44 The total cost associated with the Air Service from 7 May 2007 to 31 March 2013 was £9.01 million (Figure 2), including the £1.5 million capital cost of developing the civil terminal building at RAF Valley, the Air Service contracts and the grant funding to the Isle of Anglesey County Council for the costs associated with running the terminal building and landing fees at RAF Valley. As noted previously, the cost of the Air Service contract is now substantially higher than when the service was first introduced, mainly due to higher fuel costs and landing fees. In contrast, the costs met through the grant funding to the Isle of Anglesey County Council have reduced over time.

45 On a monthly basis, the Welsh Government provides a fixed 90 per cent of the costs to the Air Service contractors of operating the service as estimated at the start of the contract. The actual costs of running the service and the Welsh Government's subsidy payments are reconciled on a quarterly basis. Other than if additional payments are due because of increasing fuel prices, annual costs payments are kept within the annual £1.2 million cap. The payment of £1.25 million in 2012-13 included a reconciliation payment of around £50,000 relating to 2011-12. The Welsh Government makes payments to Citywing, and Citywing makes payments to Links Air.

Figure 2 – Costs associated with the Air Service, 7 May 2007 to 31 March 2013 (£ million)

Cost category	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Total
Air Service PSO contractors ¹	0.81	0.71	0.73	0.82	1.15	1.25	5.47
Isle of Anglesey Council (terminal building running costs and lease/landing fees at RAF Valley)	0.38	0.37	0.35	0.31	0.33	0.30	2.04
Capital investment to develop RAF Valley ²	1.50						1.50
TOTAL	2.69	1.08	1.08	1.13	1.48	1.55	9.01

Notes

1 Highland Airways (7 May 2007 to 24 March 2010) and Manx2/Citywing and FLM/Links Air (10 May 2010 to present). The service did not operate between 25 March and 9 May 2010.

2 This is the cost of developing the new terminal building at RAF Valley, which was completed in December 2007.

Source: Welsh Government

Performance monitoring: punctuality, load factor and passenger numbers

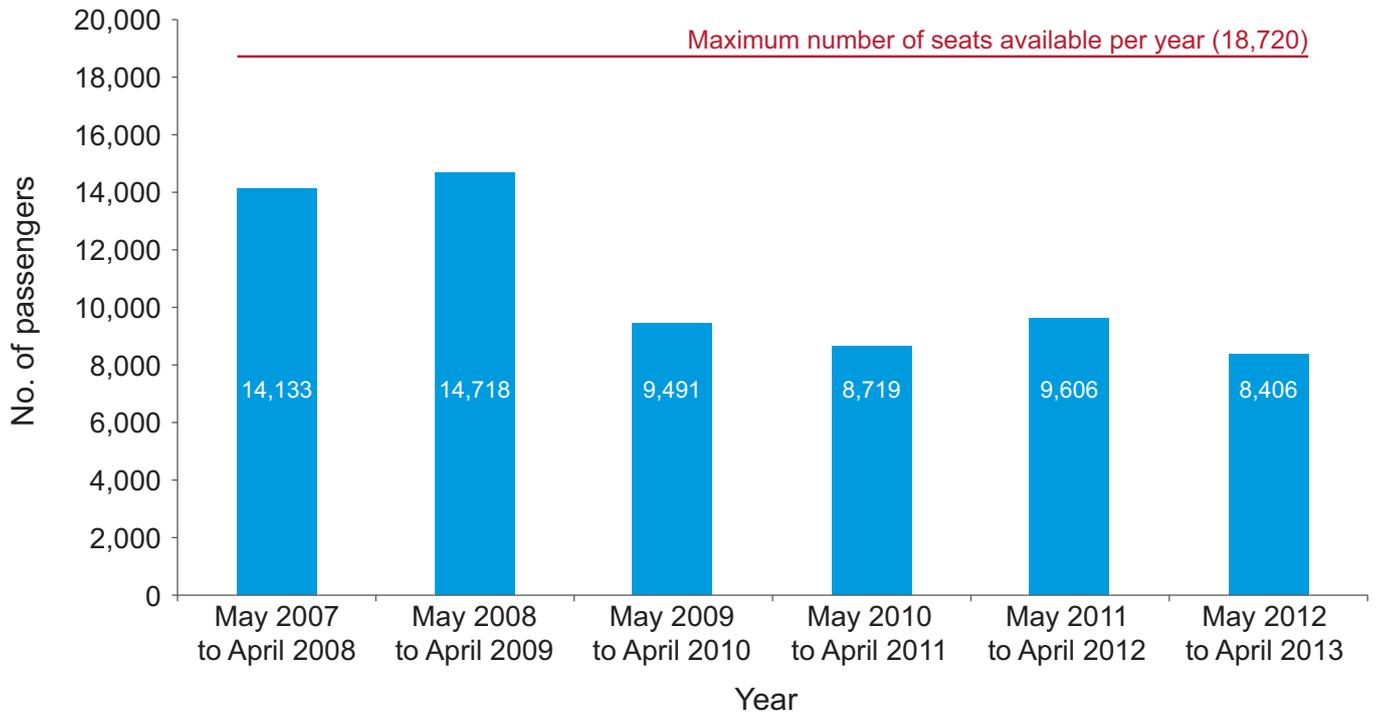
- 46** On behalf of both of the current Air Service contractors, Citywing provides the Welsh Government with monthly reports on punctuality, load factor¹⁴ and passenger numbers. For comparison with the original contract, the Welsh Government collates annual performance data on the basis of a 1 May to 30 April year, rather than the financial year. Citywing and the Welsh Government told us that performance data are discussed at monthly performance meetings, although we have not seen any documented record of those meetings.
- 47** In total, 65,073 passengers used the service between 7 May 2007 and 30 April 2013. This is equivalent to an average PSO subsidy per passenger of around £86.
- 48** During the first two years of the Highland Airways contract – May 2007 to April 2009 – nearly 29,000 passengers used the service with an average reported load factor of 82 per cent. This load factor performance compared favourably with an industry average load factor over the same period of around 76 per cent¹⁵. However, passenger numbers have been markedly lower in recent years and fell by 12.5 per cent between 2011-12 and 2012-13 (Figure 3).
- 49** Figure 4 shows seasonal variations in use of the Air Service since May 2009. The Welsh Government does not hold monthly passenger numbers for the period of operation prior to May 2009.
- 50** Regarding punctuality, on average around 90 per cent of flights have arrived on time over the full lifetime of the Air Service, some 10 per cent more than the UK industry average¹⁶. Citywing also reports on regularity of services (the proportion of flights scheduled that take place). Although there are no industry-wide figures for the regularity of services, the Air Service has operated at close to 100 per cent regularity since the recommencement of the service on 10 May 2010 following the demise of Highland Airways. Figures are not available for the first contract under Highland Airways, although Welsh Government officials told us they are confident that it was also close to 100 per cent.
- 51** A survey undertaken by Manx2 in September 2012 showed that 74 per cent of passengers rated the service as 'excellent' and 92 per cent said that they would recommend the service to other people.

¹⁴ Load factor is a measure of the amount of utilisation of the total available capacity of an aircraft. It is useful for calculating the average occupancy. Using this information, airlines can determine the profitability and revenue potential of various routes. Load factor is defined as the number of passenger-kilometres travelled as a percentage of the total seat-kilometres available.

¹⁵ International Air Transport Association (IATA), *Air Transport Market Analysis*, December 2007, 2008, 2009

¹⁶ Data is compiled by the UK Civil Aviation Authority (CAA) in co-operation with Airport Coordination Limited (ACL).

Figure 3 – Intra-Wales Air Service passenger numbers 7 May 2007 to 30 April 2013¹

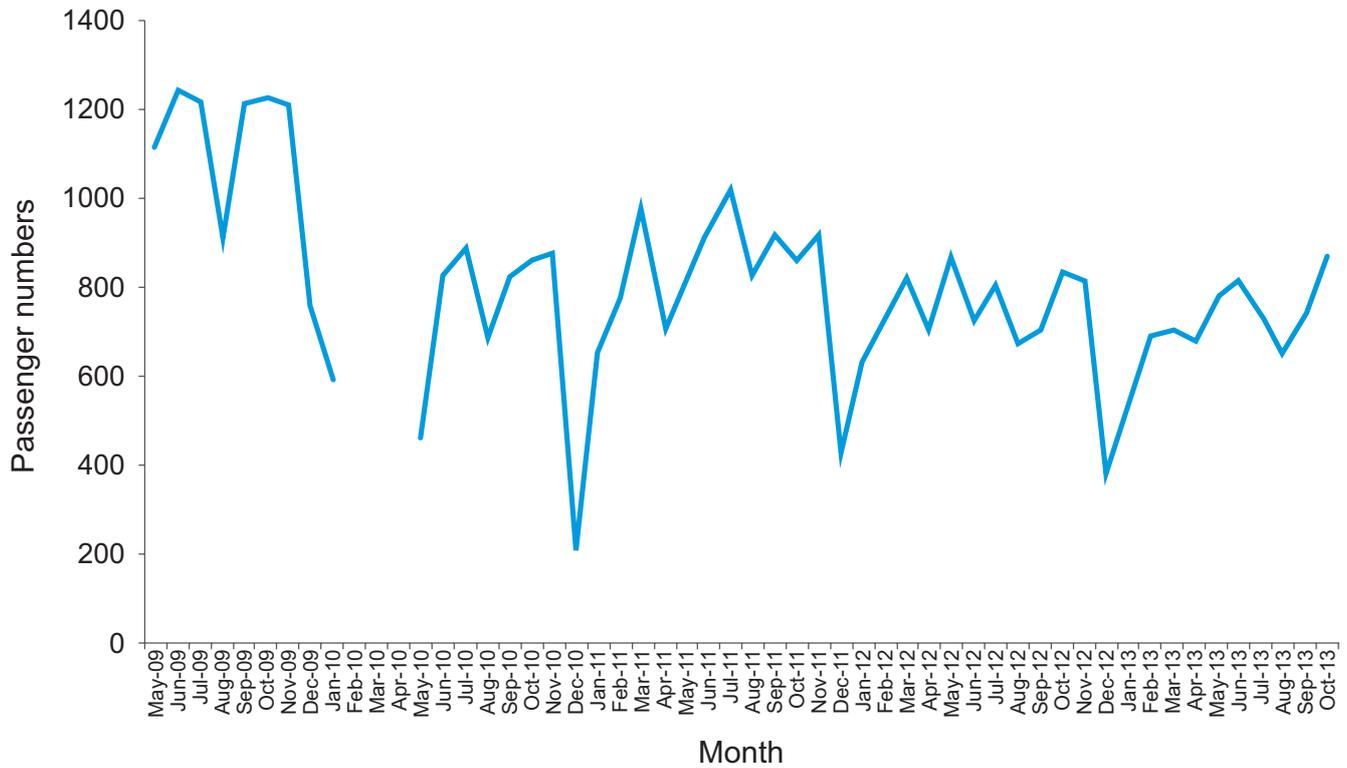


Note

¹ Highland Airways (7 May 2007 to 24 March 2010) and Manx2/Citywing and FLM/Links Air (10 May 2010 to present). The service did not operate between 25 March and 9 May 2010 and Highland Airways did not submit to the Welsh Government passenger number information for the period from 1 February 2010 to 24 March 2010.

Source: Welsh Government

Figure 4 – Intra-Wales Air Service passenger numbers by month – 1 May 2009 to 31 October 2013



Note

1 Highland Airways (1 May 2007 to 24 March 2010) and Manx2/Citywing and FLM/Links Air (10 May 2010 to present). The service did not operate between 25 March and 9 May 2010 and Highland Airways did not submit to the Welsh Government passenger number information for the period from 1 February 2010 to 24 March 2010.

Source: Welsh Government

Benefits evaluation

- 52** The Welsh Government commissioned a study in 2008 to evaluate the performance of the Air Service¹⁷. The report was based on interview surveys of passengers and found that ‘there is evidence to suggest that the air service has improved the quality of life for many passengers’. Based on the fact that 1,879 trips between North-West Wales and South Wales had been created, the evaluation also concluded that the service had had a positive impact on many sectors of the Welsh economy.
- 53** While the Welsh Government commissioned a financial appraisal of the Air Service in preparation for the procurement exercise it started in late 2009, it did not evaluate any of the benefits delivered through the introduction of the service. The Welsh Government has not commissioned any further evaluation of benefits and there is no regular benefits realisation process as part of the Welsh Government’s overall governance of the service. For example, there is limited information readily available on the purpose for which passengers use the service or with which to assess the catchment area for the service in North or South Wales. However, data from the September 2012 passenger survey undertaken by Manx2 indicated an equal split between business and leisure travellers.
- 54** Without robust benefits evaluation, it could prove difficult for the Welsh Government to continue to justify any continued subsidy of the existing Air Service in terms of demonstrating that the service is vital for the economic development of the regions it serves, especially in light of the apparent reduction in passenger numbers over recent years.

¹⁷ Halcrow, *Monitoring of the Cardiff/Ynys MonAir Service*, October 2008

Looking to the future

- 55** The current contract with Citywing is due to expire on 9 December 2014. Welsh Government officials told us that they are planning to assess the value for money of the Air Service towards the end of 2013 to help inform the future Air Service strategy.
- 56** We did not prepare this briefing paper with a view to making recommendations to the Welsh Government. However, there are a number of actions that we think the Welsh Government should consider taking as part of its assessment of the value for money of the Air Service and in planning any new contract, as follows:
- a** The Welsh Government's value for money assessment of the existing contract should look to incorporate the principles of a Gateway 5 benefits evaluation review¹⁸.
 - b** The Welsh Government should revisit the business case for the Air Service and undertake a full options appraisal and cost-benefit analysis and applying the principles set out in HM Treasury's *Green Book*¹⁹. This analysis should include examining alternatives to investment in the Air Service that could deliver the same results, for example, enhancements to rail services. The Welsh Government should take into account that there is now a different economic and public finance environment to the one when the original business case was developed. The Welsh Government should also consider the strategic fit of the Air Service with current transport and economic development policy and with its sustainable development objectives.
 - c** Any future procurement for a PSO contractor should make explicit whether the Welsh Government is open to receiving bids from consortia.
 - d** The Welsh Government should make sure that Cardiff Airport, RAF Valley and the Isle of Anglesey County Council are fully engaged in the assessment of value for money, any subsequent business case and if relevant, any future procurement exercise. In doing so, we would expect that the Welsh Government would consider how the continuation of the Air Service plays into the future development of Cardiff Airport, including links to other airports to make better use of the aircraft which currently sits at Cardiff Airport for nearly seven hours between rotations.
 - e** A robust benefits management process, based on the principles of *Managing Successful Programmes*²⁰ good practice, should accompany any new PSO contract; along with the use of Gateway reviews during the management of any new contract.

¹⁸ The Gateway Review process has been developed by the Office of Government Commerce and is based around short and focused peer review at key stages of a project or programme.

¹⁹ HM Treasury guidance on how to appraise proposals before committing funds to a policy, programme or project.

²⁰ *Managing Successful Programmes* is a framework developed by the Cabinet Office comprising of a set of principles and processes for use when managing a programme.

- 57** RAF Valley is to undertake a period of planned maintenance to the main runway, currently planned for early 2015. The project will take approximately one year and airfield operations will be limited to one runway. For a short period, likely to be around three to four weeks, the airfield will close completely. As the project is still in the planning stages, all dates and plans are yet to be confirmed.

Appendix 1 – Timeline of key events

This timeline summarises some of the key events described in the main body of this paper

December 2003	UK Government's Air Transport White paper identifies the potential for new intra-Wales air services between North and South Wales.
July 2004	The Welsh Government undertakes a scoping study to investigate the potential for a North-South Wales air service.
December 2004	The Welsh Government develops a business case which examines the costs and benefits of various route options for the Air Service.
February 2007	The Welsh Government awards a three-year contract to Highland Airways to run the Air Service between Cardiff Airport and RAF Valley on the Isle of Anglesey.
7 May 2007	Air Service flights commence.
November 2009	The Welsh Government commences the tendering process for a new four-year Air Service contract.
10 March 2010	Welsh Government officials write to the European Commission regarding the legitimacy of using an interim seven-month contract having failed to secure viable bids for the full four-year contract.
24 March 2010	Highland Airways goes out of business and flights cease.
31 March 2010	The Welsh Government commences the tendering process for an interim Air Service contractor.
20 April 2010	Welsh Government officials recommend that an interim seven-month contract should be awarded to Manx2 with its partner airline FLM.
10 May 2010	Manx2 and FLM commence flights.
9 July 2010	The Welsh Government recommences the tendering process for a four-year Air Service contract.
December 2010	The Welsh Government awards a four-year Air Service contract to Manx2 and FLM.

This timeline summarises some of the key events described in the main body of this paper

1 November 2012	FLM fails its assessment by the German Aviation Authority, loses its Air Operator's Certificate, and is unable to discharge its responsibilities as a service provider under the terms of the Air Service contract. Manx2 takes on Links Air as the carrier and informs the Welsh Government.
16 November 2012	The Welsh Government formally assigns Links Air to the Air Service contract to supply plane and crew for a seven-month 'emergency' period.
1 January 2013	Manx2 transfer its assets to a new company, Citywing.
23 January 2013	The then Minister for Local Government and Communities agrees the novation of Manx2's rights and liabilities under the contract to Citywing.
7 March 2013	The Welsh Government decides to assign Links Air to the Air Service contract for the remaining period of the contract from 17 June 2013.
March 2013	The Welsh Government writes to the European Commission setting out the arrangements it made following the removal of FLM's accreditation and appointment of Links Air to the contract for both the emergency seven-month period and the remaining period of the contract from 17 June 2013.
March 2013	Reply via telephone from the European Commission advising the Welsh Government that it would not be responding formally and would not investigate the Welsh Government's approach further unless it received a complaint from another air carrier.
9 December 2014	Current Air Service contract with Links Air/Citywing expires.