Angus Hutchinson
Carlisle City Council Planning Services
Civic Centre
Carlisle CA3 8GQ

26 June 2012

Dear Angus

Full Planning Application for the *'Erection of a Distribution Centre (inclusive of air freight and road haulage, and including integrated +3 oC chiller chamber,+12 oC chiller chamber, workshop and offices) (use classes 81 and 88), gatehouse, canteen, welfare facilities, landscaping, new access, parking and other infrastructure works (such as auxiliarv fire station, package sewage treatment works, fire sprinkler system and electrical substation) and raised and re-profiled Runway 07125.'*

Application Ref: 10/1/16

This letter provides a response to the Business Plan (and its assumptions) for the proposed airport and freight distribution centre development at Carlisle Airport submitted to Carlisle City Council by the Stobart Group. It also takes account of further supporting documents sent to Carlisle City Council, including additional analyses on the Business Plan sent on 1st June, the Business Case for air services from the airport submitted by Aer Arann dated June 2012 and comments made by York Aviation in their letter to Dickenson Dees dated 12th June 2012.

This response should be taken in association with our letter to you of 17 May 2012 and our response to the comments made by Stobart/URS which we sent to you on 30 May 2012.

As discussed with you at our meeting last week, we have sought a further opinion on the financial viability of the airport from Economic Consulting Associates (ECA) whom we work closely with. ECA has also prepared a financial analysis based on Stobart's traffic forecasts and revenue/cost parameters. As you will see from their letter, their analysis indicates that the airport operations, including the proposed new commercial services, are not financially viable in their own right. Their analysis shows that the overall project (including the freight distribution centre) is marginally financially viable but high risk – although this is based on Stobart's traffic forecasts and parameters and assumes that their stated rental for the freight distribution centre would be paid to subsidise the airport's operations and infrastructure costs. We have also prepared a financial analysis based on our own (not Stobart's) traffic forecasts and parameters which suggests that neither the airport itself nor the full project would be financially viable (ie provides an appropriate Internal Rate of Return to meet or exceed the nominal pre-tax weighted cost of capital).

Although our own analysis indicates that neither the full project itself nor the proposed airport operations themselves are financially viable, this does depend on the initial airport infrastructure and financing costs. If these can be disregarded (ie treated as 'sunk' costs - possibly as a precondition of planning consent) and Stobart agree to pay the rental for the FDC as indicated by Hyde Harrington, then the project shows positive cash flows to 2035. The airport would, however, make a loss on its commercial air services – so it may seek to discontinue these but keep general aviation operations.

Viability of air services from Carlisle airport

The viability of air services from Carlisle depends on the likely traffic levels, the achieved yields to the airline operator(s) and any technical considerations for the operation of the services. In their letter, Aer Arann (operating as Aer Lingus Regional) have indicated that they are planning to introduce double daily service to London Southend airport and a daily service to Dublin. This is not, however, a firm commitment to do so. In their traffic forecasts, Aer Arann predict that the London Southend route will capture some 40,000 passengers and the Dublin route 20,000 passengers in the first year of operation. As indicated in our letter of 17 May, we believe that these forecasts are optimistic.

In the case of the London Southend route, we do not agree with Aer Arann's analysis of the 2009 CAA Passenger Survey in which they suggest that 32,676 terminating passengers travelled to or from the Carlisle Airport catchment area to London/SE using Glasgow, Newcastle or Manchester Airports. This does depend on the boundaries of the Carlisle Airport catchment area – but, assuming this is defined as Cumbria, the figure was 14,737 rather than 32,676 passengers – which reduces the likely 'minimal' level of demand.

It is also clear that, for many potential passengers travelling to or from London and the SE, there are minimal, if any time savings over a train journey. Aer Arann's analysis assumes a flight time of 1 hour 15 minutes. We believe that, based on Aer Arann's flight sector time between Southend and Dublin, the flight time between Carlisle and Southend is likely to be around 1 hour 35 minutes (York Aviation estimate this to be longer at around 1 hour 45 minutes). This reduces the time available in London/SE for passengers making a day trip from Carlisle. For those passengers making a day trip from London/SE to Carlisle, there is very limited time available at the Carlisle end – and passengers would need to be at the airport by around 2.45 pm for a return trip.

Aer Arann have shown that the potential fares on a London Southend service would be competitive with the standard return rail fare – although this ignores the whole range of discounted rail fares available. This will substantially reduce the likely penetration of the leisure market, including any potential visitors to the Lake District.

Similar considerations apply on the proposed Dublin service. Again we believe that the traffic forecasts are too high and the yields are likely to be very low on what is predominantly a leisure market. There is a single daily service in the middle of the day, which offers less flexibility than the more frequent services to Dublin offered at Newcastle, Glasgow and Manchester Airports. Aer Arann currently operate a Dublin service from Blackpool airport. This currently attracts just over 20,000 passengers per annum – which is effectively just above a breakeven level. A new Aer Arann service to Dublin from Carlisle would capture traffic from their Blackpool service – potentially making this financially unviable. URS suggest that the Blackpool service would be discontinued if a Carlisle service were to be introduced, although there is no mention of this in Aer Arann's Business Case. We also disagree with Aer Arann that there is potential for connecting traffic through Dublin to the US. Given that there is only a single daily flight, it is unlikely that the connecting times would be suitable for both the outbound and inbound journeys.

We note that Aer Arann's Business Case suggests that there are no technical obstacles to operating to or from Carlisle airport – although we note that they state that further discussions would be held with local ATC to evaluate non-radar procedures. We have already highlighted that the lack of radar coverage at Carlisle airport might potentially be a difficulty, particularly in view of the proximity of traffic from RAF Spadeadam. We do, however, accept that Aer Arann may be prepared to operate into Carlisle without an ILS –

although we do not believe that this would be the case for many other UK (or Irish) airlines.

In summary, we believe that commercial passenger services from Carlisle are of borderline financial viability for Aer Arann (or any other operator). We recognise that Stobart Air may initially be prepared to subsidise these, either directly by financial support to Aer Arann or by reduced airport charges at Carlisle and Southend. In the longer-term, however, we cannot see how either commercial passenger or air freight services from Carlisle could be financially viable or in the interests of Aer Arann or Stobart Air.

Financial viability of Carlisle airport

We have reviewed the Business Plan and Financial Appraisal for Carlisle Airport submitted by the Stobart Group. This is dependent on several factors which we consider in turn:

Traffic forecasts

We have commented on the traffic forecasts above. In addition to the Year 1 traffic forecasts presented in the Aer Arann Business Case, we feel that the traffic growth rate used in Stobart's financial appraisal (= 4% per annum) is too high. We believe that a growth rate of 2.5% pa (as per the 2011 UK Department of Transport regional airport traffic forecasts) is more appropriate.

Current operating loss

Stobart's financial appraisal is based on a 2013 'start point' operating loss of £317,832 pa. This is substantially less than the reported loss of £514,000 pa in the year ending 28 February 2011. CAA traffic statistics indicate that aircraft movement levels declined from 18,023 in FY2010/11 to 14,910 in FY2011/12, suggesting that there is likely to have been a corresponding decline in revenue (and higher operating loss) in FY2011/12.

We also note that the reported loss of £514,000 pa in the year ending 28 February 2011 takes account of cost-savings in Carlisle staff who have transferred to the Southend airport payroll. If these staff are still working at (or for) Carlisle airport, then their costs should be included in the Carlisle figures.

Capital costs

We believe that Stobart's capital cost estimates for the airport are too low (see our letter of 17 May 2012).

Revenue per passenger

Stobart have used a figure of £8.25 per passenger to estimate total aviation-related income. This incorporates any revenue from air freight. We believe that this figure is broadly correct (we suggested a figure of £8.50 per passenger in our earlier letter, based on revenue per passenger achieved at Scottish airports - HIAL). York Aviation, however, believe that this figure should be less than £7.50 per passenger.

Stand income

We do not believe that any stand income should be included as additional revenue. The aircraft parking and storage market is very small for the types of aircraft that could operate into Carlisle. We note that Stobart state that parked aircraft could be transferred from

Southend – although this airport has supporting maintenance facilities and we do not believe that there is inadequate apron space.

Rental income

Stobart's financial appraisal includes a rental figure of £2.0m pa for the FDC which is attributable to the scheme. It is paid on the basis that the FDC can be regarded as 'airport property' so the rental covers both the building and the airport land. It must be noted that the rental is effectively a subsidy in order to maintain the financial viability of the airport. If the freight distribution centre were to be built without the associated airport infrastructure improvements and airport operations were to cease, then this rental would not be payable and the Stobart Group's overall profitability would improve by £2.0m pa. Irrespective of these considerations, we have used Hyde Harrington's lower rental estimate of £1.8m pa in our own assessment of the overall project.

Additional operating costs

We feel that the additional operating costs shown in Stobart's financial appraisal have been significantly underestimated. The costs shown only represent staff and not other operating costs and these have not been escalated by traffic growth. We note that the additional operating costs in the financial appraisal (=£500,000 pa in Year 1) are significantly less than those estimated by Mott Macdonald and shown in URS's letter of 2 September 2011 (estimated at £1,165,000 pa).

Financing costs

Stobart has not adopted a traditional approach to assess the financial viability of the project (or airport operations) eg through the calculation of its IRR (Internal Rate of Rate) to be assessed against the financing costs (ie the nominal pre-tax weighted average cost of debt and equity capital). The analysis prepared by ECA (attached) has used Stobart's parameters to calculate the IRR of both the project and airport operations. We have also prepared our own IRR analysis using our own parameters (also attached)

Additional net revenue to Southend Airport

Stobart's financial appraisal does not include any additional net revenue that would accrue to Southend airport from the operation of the Carlisle-Southend service. Stobart have indicated that this would yield some £0.6m pa. Like York Aviation, we believe that any additional net revenue to Southend should be allocated against this airport rather than Carlisle. We recognise that Stobart may receive some revenue from tickets purchased at the new rail station at Southend airport. However, the figure quoted represents some £15.00 per passenger (or £30.00 per round trip). This amount (plus the marginal operating cost per passenger at Southend) would effectively need to be added to the air (or rail) fare. It is unclear whether this has been taken into account in Aer Arann's assessment – but, together with airport charges at Carlisle and Air Passenger Duty, such additional costs are likely to make the overall door-to-door journey cost uncompetitive against direct rail travel.

Economic case for Stobart

The financial viability of the overall project is dependent on the traffic forecasts and parameters used. As indicated in ECA's analysis based on Stobart's own traffic forecasts and parameters, the IRR for the project is 10% pa. This is probably just acceptable for a low risk project – although not for one which is highly dependent on a single airline, Aer Arann, which itself receives financial support from the Stobart Group. Our own analysis shows that the annual net cash flows after the first year are very low in comparison to the investment cost resulting a net IRR of -14% pa.

Irrespective of this, airport operations in themselves are clearly not financially viable without the rental income from the freight distribution centre. ECA's analysis indicates that the IRR for aviation operations is -10% pa. Our own analysis does not show an IRR for airport operations This cannot be calculated as all the net cash flows are negative throughout the 25 year analysis period.

In view of these factors, we do not believe that it would be in Stobart's best interests to proceed with the airport infrastructure improvements, even though the freight distribution centre is, in itself, financially viable. Even if the airport were developed, we do not believe that commercial air services would themselves be sustainable in the longer term.

Despite this, our financial analysis indicates that, if the airport infrastructure capital and financing costs are treated as 'sunk costs' (eg as a precondition of planning consent), then the potential rental received from the FDC would provide the necessary subsidy needed in order to maintain commercial services at the airport. The rental paid could be reduced (effectively to the level of the airport's current operating loss) if it did not introduce (or discontinued) the commercial services proposed.

Terminal size

We assessed the size of the terminal required for Stobart's proposed operations in our revised draft letter of 17 May 2012. Our view is that this would be adequate for operations up to around 100,000 passengers pa. Stobart's forecasts suggests that traffic levels would reach 100,000 pa by 2027 and would increase to some 127,500 pa by the end of their assessment period (2032).

Congestion levels in the terminal are dependent on the number of flights handled simultaneously and the passenger loads, which themselves are dependent on the size of aircraft used. Aer Arann has indicated that they would upgrade to larger ATR 72 rather than ATR 42 aircraft as traffic levels increase. Even with the use of larger aircraft, it may still be necessary to have overlapping flights at peak times. It might be possible to use slot scheduling to avoid this – although this may not be practical in all circumstances and there will inevitably be some terminal congestion, particularly if there are any flight delays. In any event, we do not believe that these traffic levels would ever be achieved.

I hope that this provides a useful assessment of the latest information submitted to you by the Stobart Group and URS's and that this will assist in the preparation of your report to Council members. Should you require any further clarification of these points, please do not hesitate to contact me.

Yours sincerely

Peter A Forbes
Director

CARLISLE AIRPORT DEVELOPMENT - FINANCIAL APPRAISAL - 2013-2037

£000s	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	2037
Capital costs																									
- Airport infrastructure	-9,700	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
- Freight distribution centre	-14,600	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
- Total	-24,300	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Operating revenue																									
Annual Passengers																									
- London Southend	27,500	30,300	31,000	31,800	32,600	33,400	34,200	35,000	35,900	36,800	37,700	38,700	39,700	40,700	41,700	42,700	43,800	44,900	46,000	47,200	48,400	49,600	50,800	52,000	53,200
- Dublin	10,000	11,000	11,300	11,600	11,800	12,100	12,400	12,700	13,000	13,400	13,700	14,000	14,400	14,800	15,200	15,600	16,000	16,400	16,800	17,200	17,600	18,000	18,400	18,800	19,200
- Other	2,000	2,200	2,300	2,400	2,400	2,500	2,600	2,700	2,800	2,700	2,800	2,900	3,000	3,100	3,000	3,100	3,200	3,300	3,400	3,400	3,400	3,400	3,400	3,400	3,400
- Total	39,500	43,500	44,600	45,700	46,800	48,000	49,200	50,400	51,600	52,900	54,200	55,600	57,000	58,400	59,900	61,400	62,900	64,500	66,100	67,800	69,500	71,200	72,900	74,600	76,300
Annual cargo (tonnes)	450	459	469	479	489	499	509	520	531	542	553	565	576	589	601	613	626	639	652	680	709	739	770	802	836
Aviation revenue (@£8.50/dep pax)	336	370	379	388	398	408	418	428	439	450	461	473	485	496	509	522	535	548	562	576	591	605	620	634	649
Stand income	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Rental income (Freight Distribution Centre)	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800	1,800
Total operating revenue	2,136	2,170	2,179	2,188	2,198	2,208	2,218	2,228	2,239	2,250	2,261	2,273	2,285	2,296	2,309	2,322	2,335	2,348	2,362	2,376	2,391	2,405	2,420	2,434	2,449
Operating expenditure																									
Additional operating costs	-1,240	-1,366	-1,400	-1,435	-1,469	-1,507	-1,545	-1,582	-1,620	-1,661	-1,701	-1,745	-1,789	-1,833	-1,880	-1,927	-1,975	-2,025	-2,075	-2,128	-2,182	-2,235	-2,289	-2,342	-2,395
Shuttle bus	-70	-77	-79	-81	-83	-85	-87	-89	-91	-94	-96	-99	-101	-103	-106	-109	-111	-114	-117	-120	-123	-126	-129	-132	-135
Total operating expenditure	-1,310	-1,443	-1,479	-1,516	-1,552	-1,592	-1,632	-1,671	-1,711	-1,754	-1,798	-1,844	-1,890	-1,937	-1,987	-2,036	-2,086	-2,139	-2,192	-2,249	-2,305	-2,361	-2,418	-2,474	-2,530
Cash flow (Passenger/Cargo operations)																									
Current annual deficit	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514	-514
Net revenue - Southend (£10.00/dep pax)	275	303	310	318	326	334	342	350	359	368	377	387	397	407	417	427	438	449	460	472	484	496	508	520	532
Net cash flow	-23,713	516	496	477	458	436	415	393	372	349	326	302	277	253	226	199	173	144	116	86	56	26	-4	-34	-64
Net cash flow (excl FDC rental income)	-25,513	-1,284	-1,304	-1,323	-1,342	-1,364	-1,385	-1,407	-1,428	-1,451	-1,474	-1,498	-1,523	-1,547	-1,574	-1,601	-1,627	-1,656	-1,684	-1,714	-1,744	-1,774	-1,804	-1,834	-1,864
IRR - Total project	-14%																								
IRR - Aviation operations	n/a																								

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Peter Forbes
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21 June 2012

Dear Peter

Carlisle airport financial appraisal model

I have carried out a review of the financial model you sent me on 14 June 2012, identified as 'Carl Airport Bus Plan.xls' and an accompanying document 'Carl Airport Assum Bus Plan.docx'.

You have asked me to consider the appropriateness of the model for the appraisal of an investment in airport infrastructure. As you know, I am a Chartered Accountant and have specific experience in the financial modelling of airport businesses in many circumstances over the last ten years and more.

Observations on the structure and operation of the model

I have identified a number of anomalies in the model:

- Assumed cargo volumes appear to have no impact on revenues or any other part of the model.
- Although revenues per passenger are inflated by 13.1% every five years and passenger volume growth of 4% is assumed, aviation-related revenues in row 32 are adjusted only by inflation of 2.5%. In other words, these revenues per passenger and volume assumptions are not implemented in the financial model at all.
- All operating expenditure (i.e. excluding depreciation and interest) and other revenues are similarly adjusted only by inflation of 2.5%, with no reference to passenger or cargo volumes.
- Although depreciation is calculated for each year in row 99 (assuming asset lives of 40 years), depreciation is only included in the total expenditure line (row 102) for 2013, thereafter depreciation is ignored.
- The two metrics apparently used to appraise the investment are both percentage returns on equity, but the value of equity is inconsistently calculated. The model assumes £10 million of debt is repaid at a rate of £1 million each year but does not compute the cash flow implications and makes no adjustment to the value of equity. The cash flows would imply further injections of equity capital or new sources of debt. Even in terms of

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balance sheet accounting, equity measured as the depreciated value of the investment less debt would also imply significant increases in equity. Either way, the returns on equity computed would overstate the actual returns.

Taken together, these observations lead me to conclude that the model version I have seen would not be a safe basis for an investment appraisal.

Observations on the investment proposition

I have carried out a high level analysis of the investment proposition, after correcting for the error in the computation of aviation-related revenues. I have not incorporated revenues in respect of cargo and I have not corrected the model for any increases in operating expenditure arising from volume growth assumptions. This means that, in broad terms and assuming the underlying assumptions are otherwise reasonable, I would expect my analysis to overstate the level of returns.

I have separated my analysis of the business into two components – airport and freight distribution centre. I have carried out a discounted cash flow analysis to identify the internal rates of return shown by the investment on a pre-financing and pre-tax basis. This indicates the levels of overall return to investors, taking debt and equity investors together, and is a common reference point for investment appraisal. The benchmark rate of return for such an appraisal would be an assessment of the nominal pre-tax weighted average cost of capital.

I have computed internal rates of return assuming a value of the business and of its two components at the modelling horizon, at the end of 2032, equal to the depreciated book value of the investments.

The results are:

- Airport: -4% (negative)
- Freight distribution centre +15%
- Overall business +10%

A nominal rate of return of 10% on a pre-tax basis does not look especially attractive, but it is possible that it may be attractive for a low risk investment.

From my experience of considering risk and financing in the airport sector, I would observe that airports at the periphery of a regional market and at an early stage of commercial development tend to be more exposed to systematic risk than the generality of airports. It seems unlikely that this investment should be considered low risk.

The results I compute for the airport part of the business would be particularly concerning. The results, showing a negative internal rate of return, do not support the airport investment proposal taken in isolation. I note further that the pre-financing (i.e. before taking account of any debt interest, debt repayment or dividend) cash flows for the airport component are negative every year until 2027.

I conclude that, from the evidence presented in this model, I see no evidence that the airport investment is commercially attractive or that the airport would be financially sustainable, even disregarding financing costs.

Observations on scope of benefits for other airports

I understand that the investing company has expressed the view that a commercial decision to invest in Carlisle airport would be in part underpinned by significant benefits arising at another airport. Such benefits were not reflected in the model I have reviewed.

It is well recognised that commercial benefits can arise for an airport as a consequence of increasing passenger numbers. For airports in a competitive market, this influences the charges that can be levied on airlines and the prevalence of heavy discounting by airports to attract new routes is well documented. The nature of markets mean that an airport cannot rely on retaining such benefits for long. It seems implausible that benefits of this kind arising at another airport should materially underpin an investment decision at Carlisle airport.

I enclose with this letter a copy of the model with an additional sheet appended with my calculations.

I hope you find this helpful. Do please let me know if you have any queries.

Yours sincerely

Ian Rowson
Director of Regulation and Forensic Services