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## Report of the Director of Development

### Executive Board

Date: 20 September 2006

**Subject: LEEDS CITY COUNCIL'S SHAREHOLDING IN LEEDS BRADFORD INTERNATIONAL AIRPORT**

#### Electoral Wards Affected:

Citywide

#### Specific Implications For:

Equality and Diversity

Community Cohesion

Narrowing the Gap

Eligible for Call In

Not Eligible for Call In  
(Details contained in the report)

## EXECUTIVE SUMMARY

This report considers the Council's 40% shareholding in Leeds Bradford International Airport (the Airport). The report outlines the increase in passenger numbers in recent years and in turn the growing contribution that the Airport makes to the sub region. However, in recognition of increased competition in the aviation market, the Airport's need for sustained capital investment across all of its service areas, and the likely impact on future dividend returns to shareholders, the report concludes that the Airport's future success would be best served by a change in the current ownership model. In consideration of the issues outlined, and in the light of the detailed advice provided by the Council's retained consultants, Ernst and Young LLP, the report scores different options for a majority/outright disposal and, based upon the objectives set by the shareholders, recommends a 100% majority disposal of the Airport Company, subject to the agreement of the other shareholders. Alternatively, should such an agreement not be reached, it is recommended that Leeds City Council participates in a disposal of 60% or more of the company's shares that would allow Leeds to sell all of its interest in the Airport Company.

This report also makes recommendations for the:

- option to include land held by the West Yorkshire Districts in the transaction.
- proposals to protect the pension arrangements of the Airport Company's current and future employees.
- proposals for a joint indemnity agreement between the shareholders to govern the apportionment of any abortive fees should the sale not proceed
- proposals to allow bidders to come forward with their plans for retaining, developing and incentivising employees, which could include an employee share ownership scheme.
- timely disposal of the shares so as to limit the disruption to Company business and to take advantage of the current market appetite for airport disposals.

The value ranges that could accrue from a share disposal of the Airport Company will also be provided to Members of Executive Board.

## **1.0 PURPOSE OF THIS REPORT**

- 1.1 To update Executive Board on the progress made in determining the future of Leeds City Council's shareholding in the Airport and to obtain approval to Leeds City Council's participation in an outright (100%) disposal of the Airport Company in partnership with other participating Shareholders.

## **2.0 BACKGROUND INFORMATION**

- 2.1 Members of Executive Board will recall that they considered a report concerning the Council's interest in the Airport in February 2006. The report considered the Council's shareholding in the Airport in the context of:

- the ownership profile of the Airport;
- the current and projected performance of the Airport Company;
- comparisons with other airports;
- an assessment of the main issues facing the aviation market.

- 2.2 Further to consideration of the report, Executive Board resolved:

- That the City Council participate in a majority or outright disposal of its shares in the Leeds Bradford Airport Company.
- That the decision to participate in a disposal be subject to a decision by one or more of the other shareholding authorities to dispose in order to enable at least 51% of the Company to be offered to the market.
- That the City Council, in partnership with the other shareholding authorities, procure appropriate financial and legal advice to project manage the disposal.
- That the precise form of the disposal to be progressed be subject to financial advice from the retained financial consultants and be reported back to this Board at a later date.
- That the cost of financial and legal advice be charged to the purchaser as fees over and above the final capital receipt.

- That, subject to the agreement of the other participating shareholders, Leeds City Council undertakes the project co-ordination function for the disposal and that this be charged to the purchaser as part of the disposal fees.
- That the proposal to procure financial and legal advisers through the Office of Government Commerce's existing S-Cat framework be noted.
- That it be noted that the submitted report had been shared with the other shareholding authorities to aid them in their decision making on this matter.

2.3 Following the Executive Board resolution detailed above, the other four shareholding authorities have all taken decisions to participate in a majority or outright disposal subject to the outcome of appropriate financial and legal advice on the precise form of the preferred disposal option.

2.4 In order to progress this work, officers from Leeds City Council have procured advisors to act on behalf of the shareholders. Following a procurement exercise using the Office of Government Commerce's S-Cat framework, Ernst and Young LLP has been appointed.

2.5 As outlined in the February report to Executive Board, the disposal exercise has been split into three phases, namely:

- Phase 1 - financial and legal advice (after which all participating authorities will be able to take a view on their inclusion in either a majority or outright disposal)
- Phase 2 - Preparation of the Airport for marketing, the marketing of the offer and the receipt of offers
- Phase 3 - Acceptance of an offer through to completion

2.6 Accordingly, Ernst and Young LLP has completed Phase 1 of the exercise and presented their report for consideration by the shareholders.

2.7 All tenderers were invited to make proposals on the basis of both a capped fee and a fee based upon a percentage of sale price. Details are given in the confidential section of this agenda.

### **3.0 MAIN POINTS**

3.1 In determining the future of the five West Yorkshire Districts' shareholding in Leeds Bradford International Airport, it is essential to define the shareholders' objectives for the future of the airport. In this context it is important to note that recent sales of publicly owned airport's have tended to adopt bespoke transaction structures developed to meet specific operational/market circumstances and shareholder objectives. In this regard, the current operational/market position of Leeds Bradford International Airport is similarly unique, which necessitates the development of a tailored transaction structure.

3.2 In view of this situation, Ernst and Young LLP has worked with the shareholders of the five West Yorkshire Districts to define their future objectives for the Airport. In summary, the shareholder objectives that have been defined are:

- **Objective 1: To maximise the financial value to the current shareholders.**  
This objective includes the need to:
    - Objective 1.1 - maximise the value of projected cash flows to current Shareholders in terms of either a lump sum capital receipt, or future revenue flows.
    - Objective 1.2 – avoid significant levels of risk to projected cash flows to current Shareholders, including trading performance, capital cost overruns, security costs risks and new legislation.
    - Objective 1.3 – avoid material value leakage to any new owners
  
  - **Objective 2: Avoid future capital commitment by current Shareholders**
    - It is recognised that LBIA’s future success and growth in an increasingly competitive market will require significant levels of capital investment over future years. However, it is also evident that whilst the current shareholders want LBIA to enjoy capital investment, they do not want to be called upon to provide additional equity funding, given the capital investment pressures in the core service areas of the five West Yorkshire Districts’ activities .
  
  - **Objective 3: Maximise growth and success of the Airport to support the future socio-economic development of the region**
    - The Airport is an asset which is key to supporting the future socio-economic development of the City Region, with its future success being closely linked to the economic prosperity of the sub-region.
    - To achieve this objective, the five West Yorkshire Districts will need to ensure that the transaction structure identified maximises the likelihood that the business will be both robust and grow efficiently for the benefit of the sub-region and lead to:
      - improved aeronautical services, for example through enhanced numbers of routes or frequencies.
      - improved non-aeronautical services for consumers at the Airport including wider retail provision,
      - improved access to the Airport, for example through supporting regional initiatives to improve bus and rail connectivity.
- 3.3 In addition to the three primary objectives identified above, the five West Yorkshire Districts have also identified two further objectives that need to be incorporated into the preferred transaction structure, namely:
- the name of the Airport remains Leeds Bradford International Airport
  - the Airport continues to operate as an international airport business
- 3.4 Based on the objectives identified above and building on the option appraisal presented to Executive Board in February 2006, Ernst and Young LLP has reviewed the options for the most appropriate transaction structure in terms of a majority or outright share disposal.

3.5 The options that have been considered are:

- 100% share disposal
- 80% share disposal (purely for illustration, assuming Leeds City Council (LCC) and Bradford Metropolitan and District Council (BDMC) each retain 10% shareholdings)
- 60% share disposal (purely for illustration, assuming LCC and BDMC each retain 20% shareholdings)
- Do Nothing – business as usual

3.6 These options have been appraised in terms of their ability to achieve the shareholders' objectives, in terms of the Airport's current operational performance, and the future challenges to be addressed by the Airport Company. Given the significant commercial sensitivity attached to this appraisal, it is considered that the public interest in maintaining this information as exempt, outweighs the public interest in disclosing this information, as disclosure may prejudice the outcome of the disposal. Accordingly, the options appraisal is contained in the confidential section of this agenda under the Council's Access to Information Procedure Rules 10.4 (3).

3.7 The option appraisal concludes that, on balance, a 100% disposal of shares would best meet the objectives agreed by the five West Yorkshire districts and this is the option that is recommended. However, should a 100% disposal not have the agreement of all of the five shareholders, then it is proposed that Leeds participates in any disposal which can offer 60% or more of the company to the market, on the basis that Leeds City Council disposes of 100% of its shares.

#### 4.0 **ADDITIONAL CONSIDERATIONS**

4.1 In addition to identifying the percentage of shares to offer to the market, there are a number of other considerations to be taken into account in finalising the final transaction structure of the disposal exercise. Specifically, the shareholders need to consider their approach to:

- protecting the pension arrangements for existing and future employees of the Airport Company.
- the potential for an employee share ownership scheme as part of the transaction
- the future of land held by the five West Yorkshire Districts in the vicinity of the Airport's operational boundary.
- competition issues associated with the disposal of a controlling interest in the Airport Company.

4.2 **Pension arrangements** – The Airport Company currently participates in the Local Government Pension Scheme. Currently, the Airport is able to participate in this scheme by virtue of regulation 130 of the Local Government Pension Scheme (LGPS) Regulations 1997. On the basis that more than 50% of the shares will be disposed of under the transaction structure proposed, the Airport Company would no longer be able to participate in the pension scheme under this regulation.

4.3 To continue to participate in the LGPS, the company must either:

- continue to be a public airport company
- become a resolution body under Regulation 4 of the LGPS
- assume admitted body status under Regulation 5A

- 4.4 Of the options identified above, the airport company would not continue to be publicly owned and the company does not fall within the scope of Regulation 4. Admission as a transferee admission body under Regulation 5A is the route normally taken on the outsourcing of public service activities. In order to become a transferee admission body, the Company must provide a service or assets in connection with the exercise of a function of a Scheme employer, as a result of the transfer of the service or assets by means of a contract or other arrangement. Ordinarily this would operate on a best value outsourcing arrangement and it appears unlikely that a sale of the Company or the Company's business in the circumstances contemplated, could fall within the terms of this Regulation. However, there may be scope for a special approval allowing the Company to continue as a participant.
- 4.5 An alternative to continuation with the LGPS would be for a bidder to set up a Government Actuary Department approved scheme (GAD). Some bidders may already have established such schemes. Under this scenario, the new scheme would provide fully equivalent benefits.
- 4.6 Subject to compliance with dual workforce regulations, it is likely that a new owner will expect future employees to join a new pension scheme. The code of practice for a two tier workforce provides that new joiners should be offered access to a 'good quality' pension scheme, which offers fair and reasonable terms and conditions.
- 4.7 **Employee share ownership scheme** – As part of the disposal exercise, the five West Yorkshire Districts could decide to include an employee share ownership scheme as part of the transaction structure. In essence, this provision would provide a pre-determined percentage of shares in the Airport Company, for purchase by existing employees of the Airport Company at market value. The advantage of such a scheme to the shareholders is that it would help to incentivise employees during the disposal process, on the basis that employees had the opportunity to directly benefit from the exercise. However, introducing a scheme of this nature would lengthen the disposal timescale, could be viewed negatively by a future owner and be reflected in the value realised during the disposal.
- 4.8 In view of the above, it is proposed that, as part of the offer put to the market, bidders are asked to outline their approach to retention, development and incentivisation of employees, which might include the introduction of an employee share ownership scheme.
- 4.9 **The future ownership of land held by the five West Yorkshire Districts** – Historically, the five West Yorkshire Districts have owned a number of land parcels within the vicinity of the Airport. Largely, this land is let for agricultural purposes. Some of this land lies within the Airport Operational Boundary and some lies outside of it.

- 4.10 The published Master Plan of the Airport identifies the planned long-term development of the Airport within the operational boundary defined by the Adopted Unitary Development Plan for Leeds (see Appendix 1). Given that bidders may be keen to ensure that they have the ability to deliver the Airport's Master Plan, it is considered appropriate for the transaction structure to include that land owned by the five districts, which falls inside the Airport Operational Boundary. At the same time, Members are also requested to delegate authority to officers to dispose of other five districts' land outside of the Operational Boundary as appropriate and subject, as always, to the requirement to achieve best consideration.
- 4.11 **Competition Issues** – One of the risks associated with the transaction is that a new or subsequent owner of the Airport Company may own a material interest in a competing airport.
- 4.12 During the sale process, it is proposed that the five West Yorkshire Districts implement a transaction structure that allows for bids which give rise to competition issues to be managed effectively. It is proposed that bidders will be required to provide a certificate, or reasoned statement, with supporting evidence, demonstrating to the shareholders' satisfaction that all competition clearances required are likely to be received, and that the impact of acquisition will not impact on competition issues in the market.

## **5.0 TRANSACTION TIMETABLE**

- 5.1 The advice received from Ernst and Young LLP is that there is currently significant appetite in the market for regional European airports like Leeds Bradford International. In this sense it is considered timely to bring forward a share disposal to the market. However, it is also recognised that this situation could change. An international incident, that affects the aviation industry, could dampen market appetite. Similarly, there is the prospect that BAA could be broken up by the Competition Commission (and become a distraction for potential LBIA bidders) and the potential for aviation fuel excise duty to increase over time, is also a consideration.
- 5.2 Added to the above, bidding for this share offer is likely to be an expensive and time consuming exercise. It is recognised that bidders will need confidence that the transaction will be completed on a timely basis. Also a timely disposal will limit any disruption to the continuity of the Airport's business caused by the disposal process. Accordingly, Ernst and Young LLP has proposed a transaction timetable that will aim to achieve financial close in March/April 2007. It is proposed that the share offer is marketed on an international basis and, given the shareholders' objectives outlined, short-listed bidders will be asked to submit detailed business plan proposals. This will enable the shareholders to assess the potential for bidders to achieve the socio-economic objectives that they are seeking to achieve through the disposal exercise.

- 5.3 In order to achieve financial close within the timescale outlined, it is proposed to invite best and final offers from bidders in February 2007. This will enable officers to report to Members in March/April 2007 on:
- the value of the best and final offers received.
  - the identity of the two bidders who have made the best final offers.
- 5.4 It is proposed that at this point in the transaction process, Members of Executive Board will be asked to consider whether they wish to proceed with the highest scoring best and final offer made and appoint that bidder as the “preferred bidder” and (at their discretion) appoint a second ranked bidder as “reserve bidder”, with the Directors of Development and Corporate Services being given delegated authority to complete the transaction with the preferred bidder nominated within a set value range of the best and final offer.

## **6.0 RISK MANAGEMENT**

- 6.1 There are a number of risks associated with the Council’s future shareholding of the Airport Company. Progressing the disposal brings with it the potential that the exercise is not completed. This could occur for a variety of reasons, including:
- A change of intent by one or more shareholders
  - An international incident affecting the aviation industry
  - A lack of market appetite for the Airport Company
- 6.2 In addition, there are risks to the five West Yorkshire Districts over the future operation of the Airport Company once the transaction is completed.
- 6.3 Not progressing a disposal at this time also carries a number of risks. The shareholders would miss out on a sizable receipt and not take advantage of the current market conditions. In addition, the Airport Company would not attract a strategic investor who would invest capital to enable LBIA to optimise its future growth potential. On the basis that the five West Yorkshire Districts have no appetite to invest capital into the business, this scenario could severely hamper the ongoing development of the Airport.
- 6.4 In recognition of the strategic importance of the Airport to the sub-region, it is proposed that the greater risks are associated with not progressing a disposal at this time. Whilst there are a number of risks associated with progressing a disposal, it is considered that, for the benefit of the future development of the Airport, there is an imperative to act at this time and take the share offer to the market.
- 6.5 Phase 1 is a key stage in the process. It is essential that a firm decision is taken on the structure of any transaction to provide certainty and thereby credibility to bidders. It is important to understand that if bidders start work on the basis of an “in principle” decision at Phase 1, any reversal in that decision will have a very detrimental effect on the credibility of shareholders in any future transaction.



## **7.0 CONCLUSIONS**

- 7.1 Leeds Bradford International Airport is at a pivotal point in its development. The Airport has experienced strong passenger growth in recent years and this trend is forecast to continue. Critically, the future success of the Airport contributes to the economic prosperity of the sub-region and in order to maintain its growth in a competitive market place, it is recognised that a new strategic investor is required to optimise the significant growth potential that exists in the business.
- 7.2 To optimise the Airport's growth potential, any new owner will need to invest capital into the business and be confident that they will have sufficient flexibility to guide its future direction. To best achieve this outcome it is proposed that the five West Yorkshire Districts progress the disposal of 100% of the shares in the Airport Company. However, should a 100% disposal not have the agreement of all of the five shareholders, then it is proposed that Leeds participates in any disposal which can offer 60% or more of the company to the market, on the basis that Leeds City Council disposes of 100% of its shares.

## **8.0 RECOMMENDATIONS**

- 8.1 Members of Executive Board are asked to:
- approve that Leeds City Council will, subject to the agreement of the other West Yorkshire Districts, participate in the disposal of 100% of shares in the Leeds Bradford International Airport Company and, subject to the agreement of the four other West Yorkshire districts, instruct officers to progress such disposal in a timely manner.
  - In the event that not all of the five shareholders agree to participate in a 100% disposal, to approve that Leeds City Council participates in a share disposal of 60% or more in the Airport Company, on the basis that Leeds City Council would sell 100% of its interest in LBIA.
  - agree that officers of the five West Yorkshire districts draw upon the objectives detailed in this report to determine the criteria to be used in the future assessment of the submitted bids.
  - Approve that, subject to proper consultation and compliance with legal requirements, the proposal that bidders will be asked to implement pension arrangements that grant, for existing employees, fully equivalent pension benefits to the existing Local Government Pension Scheme and offer new employees, at the option of the new owner, membership of a final salary scheme, or a money purchase scheme.
  - approve the proposal that bidders, as part of their submissions, be asked to explain their company culture with regard to staff retention, development and incentivisation.
  - approve that any land owned by the five West Yorkshire districts which lies within the Airport's Operational Boundary be included with the disposal of the Airport Company, and that officers be given delegated authority to determine whether it is appropriate to also include other five districts' land which is in the vicinity of the Airport Operational Boundary in the disposal, subject, as always, to the requirement to achieve best consideration.

- instruct that officers bring back a report to Executive Board seeking endorsement of the preferred bidder identified and the acceptance of the best and final offer made, to enable the transaction to be completed.
- and, with reference to the confidential appendix (Appendix 2) to be circulated at the meeting:
  - note the scale of the potential receipt that could accrue to the Council from a share disposal of Leeds Bradford International Airport.
  - note and agree the Ernst and Young LLP scales of fees that will be incurred during the three phases of the disposal exercise and which will be charged to the purchaser upon completion of the transaction, and to delegate to officers the authority to select that fee structure which best incentivises the consultants to optimise the disposal proceeds.
  - delegate authority to officers to commission the vendor due diligence work required and also other technical consultancy advice as appropriate.
  - approve that Leeds City Council enters into an indemnity agreement with the other West Yorkshire districts, as set out, to govern the apportionment of any abortive fees incurred should the disposal transaction not complete and to instruct the Director of Corporate Services to make provision for any liabilities arising under this agreement and for any other abortive Leeds City Council costs.

**Background Papers used in the preparation of this report:**

Leeds Bradford International Airport Share Disposal Phase 1 Report to Shareholders, August 2006 (This report has been classified as confidential under Access to Information Procedure Rule 10.4(3)).