

Review of Cairngorm funicular railway



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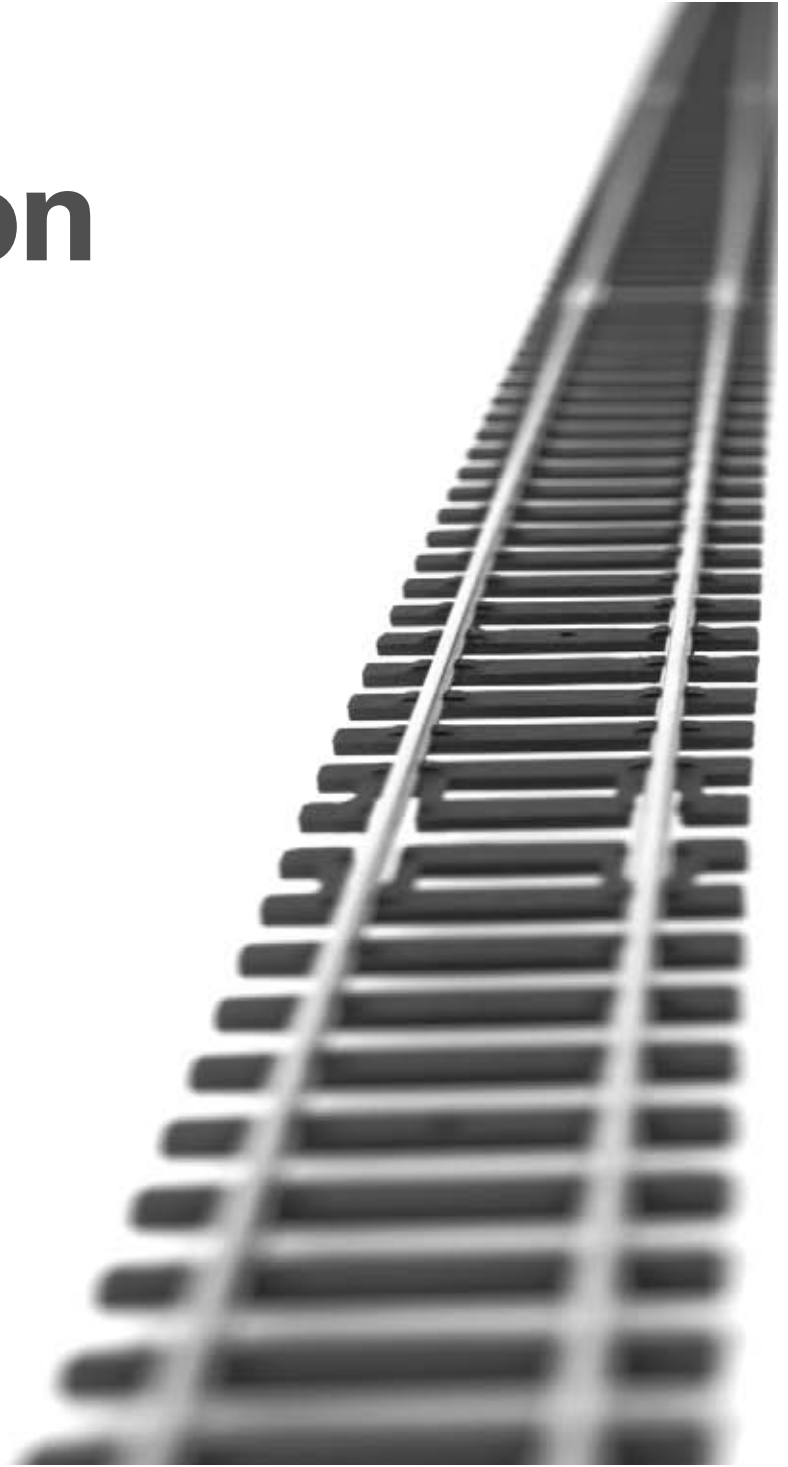
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Introduction



The public sector has invested over £23 million in the funicular, of which HIE invested £19.4 million.



The Cairngorms are the main location for skiing in Scotland

1. Since 2001, Cairngorm Mountain Limited (CML) has transported visitors to skiing and other recreational facilities near the summit of Cairngorm by means of a funicular railway.
2. The Cairngorms are important for recreation and nature conservation. Downhill skiing is a major activity in the area and it is also used for hill walking, rock climbing, grazing reindeer and scientific research. The Cairngorms are environmentally fragile, and contain one of the largest bird reserves in Europe and several other sites protected under United Kingdom and European Union (EU) legislation.
3. The ski area occupies 844 hectares on the north facing slopes of the Cairngorms. Highlands and

Islands Enterprise (HIE, formerly the Highlands and Islands Development Board) became the owners of the estate in 1971 when the Secretary of State for Scotland decided that it was no longer needed for forestry and ordered its transfer from the Forestry Commission for Scotland.¹ This was to ensure and enable the controlled and proper development of winter sports in the area and proper provision for the maintenance of the estate.

4. The Cairngorms are the main location for skiing in Scotland and catered for around two-thirds of total skiing demand between 1960 and 1990. Skiing was vital to the growth of Aviemore and Strathspey and led to the development of accommodation and other visitor attractions.

5. The Cairngorm Chairlift Company Limited operated the skiing facilities

at Cairngorm on HIE's land. The Chairlift Company became Cairngorm Mountain Ltd (CML) in January 2001. For consistency, we have referred to the company as CML throughout the rest of this report. Up to May 2008, the Cairngorm Mountain Trust Ltd owned CML.²

6. CML opened the first chairlift at Cairngorm, the White Lady chairlift, in 1961. The Car Park chairlift opened in 1965. Uniquely among Scottish ski resorts, the good skiing areas for beginners are at the higher altitudes of Cairngorm. This increases the likelihood of snow, but requires an efficient and effective means of transporting all types of skiers up the mountain.

7. CML has two skiing areas on Cairngorm, at Coire na Ciste and Coire Cas. Access is provided by the funicular railway and ten tows (Exhibit 1).

Exhibit 1

Map of Cairngorm ski area



Source: Provided by Cairngorm Mountain Limited

1 Highlands and Islands Enterprise took over the functions of the Highlands and Islands Development Board (HIDB) and the Training Agency in Scotland in 1991.
 2 Cairngorm Mountain Trust Ltd is a registered charity whose objectives are environmental management, education and the provision of recreational facilities. CML was the trading arm of the Trust until 2008.

HIE regarded the funicular as key to the regeneration of Strathspey

8. By the 1990s, the Aviemore area was in decline as a tourist destination. The local enterprise company (Moray, Badenoch and Strathspey Enterprise (MBSE)), with other interested public bodies and businesses, formed the Aviemore Partnership in 1994 to identify ways to revitalise the local economy.³

9. HIE developed a strategy for regenerating the area that included modernising the facilities at Cairngorm through the funicular investment, the creation of the Cairngorm National Park and the redevelopment of Aviemore.

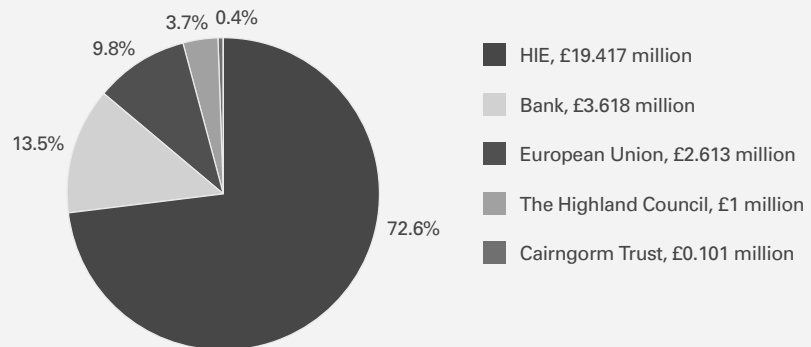
10. There was widespread local support for improving the area but different views on how this could best be achieved. One group (Save the Cairngorms Campaign and Scottish Wildlife and Countryside Link) put forward an alternative proposal for developing the Cairngorm area in March 1996.⁴ The group proposed using a gondola to a different part of the ski area, at Coire Cas, but the group had not fully developed or costed the proposal. HIE and the Highland Council (the council) did not formally consider the proposal as an option for developing the area. As the planning authority, the council could only consider the planning application received from CML. HIE endorsed the council's approach, responding that the discussions taking place between Scottish Natural Heritage (SNH), CML and the council should be allowed to proceed to a conclusion.

11. CML had assessed the group's proposal using the gondola option and sent a critique of it to HIE. HIE accepted CML's conclusion and used it in its business case for the funicular, stating that the alternative would offer less employment, visitor appeal and environmental protection

Exhibit 2

Total cost broken down by source

The public sector has spent £23 million on the funicular and operator to date, most of which was provided by HIE.



Note: We have not included within our estimates the cost of any of the time spent by HIE network staff in monitoring and supporting the project, although this is likely to be significant. The cost to HIE includes £629,000 owed by CML for unpaid rent and dividends, which HIE could have used for other purposes, and £85,989 which was repaid by the Scottish Government to the EU following an audit. The total for HIE excludes the amount paid to the bank to purchase the bank's security. Source: Audit Scotland

and would create a lower quality skiing experience at greater cost. Therefore, HIE did not undertake a wider assessment of the options and consider the group's proposal alongside CML's proposal.

The public sector has invested over £23 million in the funicular and its operator, of which £19.5 million was for its construction

12. The public sector, in particular HIE, has provided significant financial and other support to the project and the operator. To date, HIE has invested £19.41 million in the funicular and operator.

13. We estimate that it cost £19.54 million to construct the funicular. When we include the other support provided to CML since 2001, the total cost is £26.75 million. The public sector has provided around 86 per cent of this total (Exhibit 2). We provide further details on how we have arrived at these costs in the rest of the report.

14. After construction, CML struggled financially and, in May 2008, HIE announced its decision to take over CML.

15. The funicular has been the subject of public and media interest since it was first proposed. Concerns have focused on whether the initial project was based on sound assumptions and analysis and whether it was appropriate to continue to commit public funds to this project.

16. The National Audit Office (NAO) examined how the project appraisal was conducted in response to correspondence from a member of the public in 1999. The NAO's work was limited to examining the process followed during the appraisal and we understand it did not consider the underlying assumptions. It found that the appraisal covered the expected examination of the economic, environmental and financial impact of the project as required at the time. The appraisal was conducted by professional staff employed by HIE

3 At the time the HIE network comprised HIE and ten local enterprise companies (LECs) and most of HIE's functions were contracted out to the LECs. LECs were private sector companies controlled by boards of directors drawn from the private sector and the wider community. LECs had the freedom to develop programmes to meet local needs and opportunities, but used HIE's specialist technical support staff for complex or large-scale projects.

4 *The Northern Cairngorms: an alternative approach*, Save the Cairngorms Campaign and Scottish Wildlife and Countryside Link, March 1996.

Exhibit 3**Funicular project timeline**

1992	Arthur Andersen appraises options for the funicular	
1993		
1994		1994–1996 CML seek planning permission and consult with key groups
1995	Consultants estimate cost at £16.3 million	
1996	HIE Business Growth team complete the business case and submit it to the HIE Board	
1997	The Highland Council approves the planning application, subject to 34 conditions	
	HIE revises the business case, creating a project costing £14.8 million	
	HIE Board approves funding for the funicular	
	HIE applies for European Regional Development Funding (ERDF)	
	Secretary of State and the EU approve funding, but EU funding conditions are still to be agreed	
1998	Judicial review	
1999	Project managers issue invitations to tender for the three main funicular contracts	
	The National Audit Office (NAO) reviews the application and approval process	
	Construction starts after delays in finalising terms and conditions with the EU	
2000		
2001	HIE commissions consultants to appraise CML's financial position	2001–2008 HIE monitors CML closely and offers further support
	Funicular opens	
2002		
2003	HIE agrees the final cost of the project at £19.5 million (£4.9 million – or 34 per cent – above the 1997 target cost)	
2004	HIE reduces base rent to £100,000 per year	
2005		
2006		
2007		
2008	HIE takes CML into public ownership	

Source: Audit Scotland

and was supported by consultants' advice on visitor numbers. The NAO examined the project documentation held by HIE and the Scottish Office and was satisfied that the appraisals complied with the standards required for such projects and were supported by reports on economic impact and other independent advice from expert consultants.⁵

17. In October 2008, the Auditor General for Scotland informed the Scottish Parliament that Audit Scotland would undertake a specific review of the funicular project and examine HIE's plans for the future operation of the facility and relevant historical events and activity (Exhibit 3). At the time that we prepared our report, HIE was still considering options for the

future operation of the funicular and so we have not been able to examine HIE's proposals for this.

About the study

18. Although the development of the funicular was initiated before devolution, our review looks at the key decision-making stages from the funicular's inception and how public funds were used and monitored. The report is organised into three sections:

- Evaluating and approving the funicular project (Part 1).
- Building the funicular (Part 2).
- Securing the benefits of the funicular (Part 3).

19. We used a range of methods to obtain our evidence:

- A review of relevant documents, including board papers, monitoring reports and internal and external reviews from the NAO, the Scottish Government, the European Union and HIE's internal and external auditors.⁶
- Analysis of the costs of the funicular and funding sources.
- Analysis of CML data on use of the funicular.
- Interviews with HIE and Scottish Government officials, CML staff, the Highland Council staff, and former employees of HIE and CML who were involved with the project in its early stages.

20. Our review covers almost 20 years. This presented challenges in identifying and finding key documents and establishing if the processes followed met the requirements of the time. Many of the staff involved in the early stages of the process have since changed jobs or retired. The elapsed time and the unique and complex nature of the project are important factors when considering this report.

21. A review of HIE's project appraisal manual shows that HIE has already improved its procedures for the management of major projects and now uses, for example, risk and benefit analysis tools, risk registers and appraisal and implementation plans. Audit Scotland has prepared a good practice checklist on the management and governance of major capital projects.⁷

Key messages

- The business case was subject to appraisal by HIE, the Scottish Office and the EU, and met requirements at the time.
- A number of changes took place in the early stages of the project. HIE did not review and adjust the business case before construction started to take account of the increased risks.
- Although HIE provided ongoing support, CML continued to struggle and HIE took CML into public ownership in May 2008.
- The funicular cost much more than originally anticipated, but consultants report that it has delivered the anticipated employment and wider benefits to the Strathspey area.
- HIE is working with CML to develop a new business model for the funicular.

Recommendations

In developing a new business model for the funicular, HIE must ensure that it:

- fully assesses and manages all the risks and constraints facing the facility
- reviews current performance against capacity

- considers likely demand from different user groups
- develops a clear set of objectives for the business, with measurable outcomes
- provides prospective operators with a detailed analysis of the challenges faced, drawing on experience to date
- considers changes in market, environmental and financial conditions
- creates a sustainable and attractive business opportunity for any new operator.

When assessing bids for the business, HIE should ensure that prospective operators:

- are aware of the current risks and make adequate provision for them
- will offer activities that have a positive impact on the surrounding area, taking account of possible displacement
- will observe any requirements in place to protect the fragile and unique environment of the area
- have developed a financially sustainable model for the business.

If HIE cannot find a suitable operator for the funicular, or is unable to develop a sustainable business model, it will need to decide on an appropriate course of action.

HIE should continue to review and update its project appraisal processes to ensure it is adopting good practice.

6 Prior to 1 April 1999, the Scottish Office was the administrative department of the UK government with responsibility for Scottish affairs. The Scottish Executive took on some of these responsibilities after devolution. After September 2007, the Scottish Executive became known as the Scottish Government.
7 This can be found at http://www.audit-scotland.gov.uk/docs/central/2008/nr_080624_major_capital_projects_checklist.pdf

Part 1. Evaluating and approving the funicular project



The appraisal and approval process for the funicular met requirements at the time.



Key messages

- The proposal was subject to appraisal by HIE, the Scottish Office and the EU, and met requirements at the time.
- From the outset, HIE was aware of a number of risks facing the project.
- The Highland Council, HIE, the Scottish Office and the EU approved the proposal, subject to a number of important conditions.

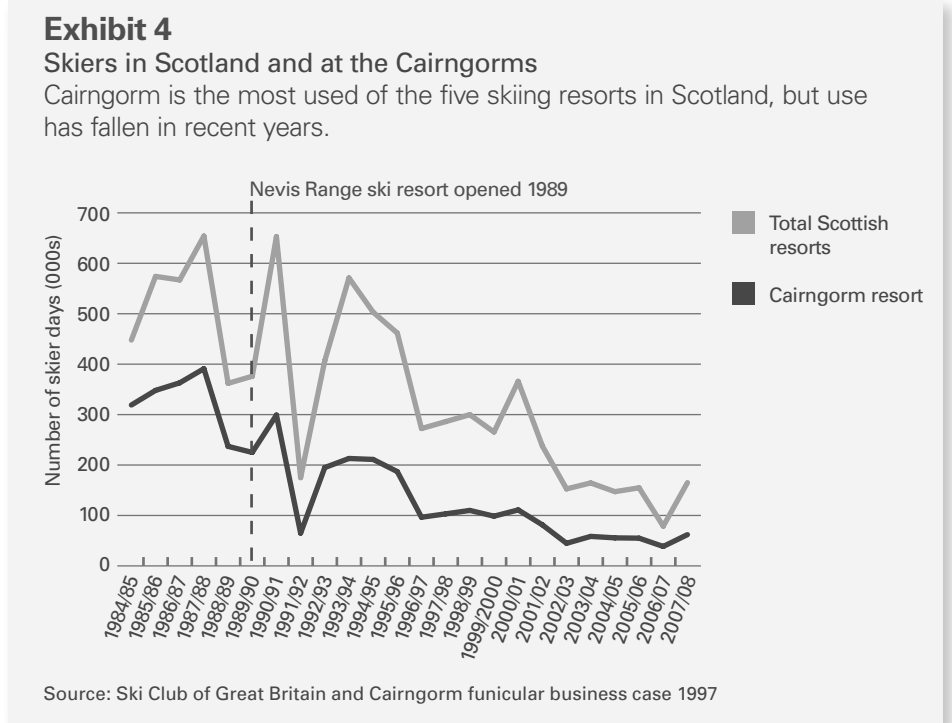
CML sought financial assistance to modernise its facilities

22. Although Cairngorm was the main Scottish skiing resort in 1992, it was facing increased competition from the Nevis Range in west Scotland, which opened in 1989 (Exhibit 4).

23. It also faced competition from other European skiing destinations that had become more accessible through cheaper air travel. After more than 25 years' use, the White Lady and Car Park chairlifts were at the end of their expected life and compared unfavourably with the systems used at other ski resorts. CML needed to upgrade its facilities to remain viable.

24. CML discussed options with MBSE. However, all of the options were likely to involve significant expenditure and so any offer of funding support required the involvement of HIE's Business Growth team. In 1992, CML, MBSE and HIE asked Arthur Andersen and Company and L&R Leisure plc to conduct a feasibility study on the options for the replacement of the White Lady and Car Park chairlifts. The investment aimed to reduce CML's dependence on winter income by providing a modern covered uplift system that would attract visitors all year round.

25. The consultants considered four options along the route of the White Lady and Car Park chairlifts. They also



considered the 'do nothing' option of continuing with the existing chairlifts. The options were:

- a replacement chairlift
- a mono-cable gondola (a cable car where the cabins are suspended from a single rope that moves between towers along the route)
- a dual-cable gondola (the cabins on this system hang from two parallel moving ropes making the system more stable in windy conditions)
- a funicular (a rope drawn railway on a single track with a short length of double track that allows ascending and descending carriages to pass each other).

26. The consultants used six criteria to assess the options, with each criterion given equal weight. The criteria were: protection from the weather; performance in the wind; accessibility; flexibility; the quality of the ride; and the marketability of the system. The consultants also considered cost, based on broad estimates of the likely cost of each option (Exhibit 5).

27. All of the alternatives offered advantages over the existing chairlifts but the funicular scored highest against the criteria. Although it was the second most expensive option, it was considered to offer a number of advantages over the alternatives, such as: attracting summer visitors thereby reducing the reliance on winter income; appealing to a wider number of potential customers such as older or disabled people; minimising queues; increasing the number of passengers that could be transported; and operating in high winds. Because of this, all future development work by HIE and CML concentrated on the funicular option.

28. The consultants developed and provided cost estimates based on a range of designs, with costs ranging from around £15 million to £21 million. In 1996, the consultants estimated it would cost £16.3 million for the funicular railway and buildings.

Exhibit 5

Outcome of the consultants' assessment of options in 1992

The consultants assessed performance against six quality criteria and cost.

	Option 1: Existing chairlift	Option 2: Replacement chairlift	Option 3: Gondola (mono-cable)	Option 4: Gondola (dual-cable)	Option 5: Funicular
Weather protection: protect skiers and other users from wind and rain	1	2	3	3	3
Performance in the wind: operates in a wide range of wind conditions	1	2	3	3+	4
Accessibility: be accessible to most customers directly from the car park level	1	2	3	3	4
Flexibility: transport sufficient numbers of skiers to the upper slopes to cope with peak demand loads	1	2	2	2	3
Ride: incorporate the ride as part of the experience	1	1	2	2	4
Marketability: to be able to be marketed as a unique attraction, to maximise draw	1	1	2	2	4
Quality total	6	10	15	15+	22
Total cost (£ millions)	£4.4 ¹	£9.7	£11.6	£13.0	£12.2

Key: The options were ranked for each quality criterion. The higher the score, the better the performance on that criterion.

Note 1: Assumes the buildings are improved to the same standard as in the other options.

Source: Audit Scotland/Arthur Andersen

HIE developed the business case

29. Current best practice requires business cases to bring together:

- a clear strategic rationale for the project and clear objectives
- an option appraisal, with detailed assessment criteria
- a financial appraisal
- a procurement strategy
- governance arrangements
- a risk assessment and a plan to mitigate risk
- agreed tolerances for cost, time and quality, with clear escalation procedures should the level of risk fall outside agreed limits.

30. HIE's Business Growth team prepared the business case to develop the funicular. HIE used consultants to supplement its own expertise, to estimate visitor numbers and to assess the potential economic impact of the funicular, including the effect of different numbers of visitors and the impact on other ski locations in Scotland. The business case included: an assessment of the strategic importance of the project to the area; the option appraisal completed by Arthur Andersen; and a financial appraisal of the project. HIE's procedures at the time did not require its business cases to detail the expected procurement strategy (although some consideration of procurement options was included in the business case) or governance arrangements or to include a detailed risk assessment and a risk management plan.

31. HIE's approach to project appraisal has evolved since 1997 and the appraisal process now requires an exit strategy and consideration of the level of contingency within the costs. HIE did include a contingency of around four per cent in the initial budget estimates. It began developing an exit strategy in 2001 to end its involvement with the funicular.

The appraisal and approval process met requirements at the time

32. HIE, the Scottish Office and the EU all appraised and evaluated the business case for the funicular in 1997. HIE developed the business case in line with its requirements at the time and submitted it to its board for approval. The EU appraised the business case before making an offer of funding in 1997 and, in 1999, the NAO reviewed the process followed

by HIE when developing the business case.

33. Current practice also stresses the importance of independent review. The person accountable for project delivery should commission an independent review at key stages to get assurance about the readiness of the project to proceed.⁸ Since 2005, 'gateway reviews' have been mandatory for all Scottish Government projects costing over £5 million deemed 'high risk or mission critical'.⁹ HIE now uses independent project reviews routinely and undertook a gateway review for CML in 2003.

HIE was aware of the risks facing the project

34. Current good practice in risk management requires a clear framework for identifying, managing and reporting risk and a clear strategy from the outset for dealing with change as projects evolve. Although HIE was not required to prepare a formal risk assessment, it was aware of a number of risks:

- Climate change. There was evidence that skiing in Scotland was in decline due to climate change. Use of ski resorts in Scotland had peaked in 1988 at 654,000 skier days, with 60 per cent (391,000) of these at Cairngorm. However, by 1997, the Scottish figure had fallen to 272,000, with 96,500 (35 per cent) at Cairngorm (Exhibit 4, page 8). The Climate Change Impact Reviews Group concluded in March 1996 that 'the viability of the Scottish ski industry was at risk from less snow and less certainty of snow at critical holiday periods'.¹⁰ While the business case acknowledged that the project

was subject to the vagaries of the weather, it did not consider the impact of long-term changes in weather patterns.

- Limited private sector investment. HIE had tried, but was unable, to persuade private sector investors to get involved.¹¹ Only the Bank of Scotland was willing to provide funding, through a commercial loan to CML of £2.5 million. Public sector funding was required for the remaining 83 per cent of the cost. This meant that the public sector was carrying most of the risk for the project.
- The complexity of the project, in particular the need to meet environmental requirements, which would add to the cost of construction.
- The need to restore the land and dismantle the facilities if skiing ceased. The national skiing guidance, issued in June 1997, set this condition but there is no reference to it in the business case.¹² The likely costs were unknown. As the operator of the facility, CML was responsible for reinstating the land if the funicular ceased operating. However, as the landlord, HIE became responsible if CML was unable to meet this obligation.
- CML's weak financial position. CML was operating at a loss and had last reported a profit in 1991. HIE recognised this but attributed it to the lack of snow cover in recent years and the dependence on winter visitors.

35. HIE's Business Growth team submitted the business case and application for funding of £16.3 million to the HIE Board in February 1996.

The planning process was protracted and delayed the start of construction

36. The HIE Board approved the business case in February 1996 but it was not sent for approval to the Secretary of State for Scotland as planning permission and clarity on the overall funding package were still needed.

37. CML had consulted widely on the project in its early stages and held meetings with key interest groups, such as the Cairngorm Partnership, Save the Cairngorms Campaign, Royal Society for the Protection of Birds (RSPB) and SNH. CML submitted the initial planning application in 1994 and revised it twice before it was subject to a public hearing in 1996.

38. The project could not proceed without the approval of SNH, which raised various objections to the plans, resulting in the redesign of some elements.¹³ In March 1996, at the time of the public hearing, SNH had two main remaining areas of concern. These centred on the arrangements to control visitor access from the site to other parts of the Cairngorms and worries about the damage caused to the environment during construction. SNH withdrew its objections when HIE, the council and CML agreed a visitor management plan and assurances were given that the construction would minimise environmental damage. The visitor management plan created a 'closed system' around the top station, which limited direct access to the mountain outside of the skiing season.

8 *Review of major capital projects in Scotland: Good practice checklist for public bodies*, Audit Scotland, June 2008.

9 The Scottish Public Finance Manual.

10 *Review of the potential effects of climate change in the United Kingdom*, United Kingdom Climate Change Impacts Review Group, for the Department of the Environment, March 1996.

11 The Nevis Range development cost £7 million and attracted £3.715 million of private sector investment. However, investors had not received the expected return from their investments; this limited interest in investing in the Cairngorm funicular.

12 *National Planning Policy Guidelines 12 – skiing developments*, Scottish Executive, June 1997.

13 SNH exercises nature conservation powers over Scotland's natural environment.

39. The council approved the planning application in March 1997, subject to 34 conditions. Reflecting the national skiing guidance, one of the conditions required CML to remove the funicular and buildings, and restore the land, if the facilities did not operate for any period of 12 months (although this could be extended by a further 24 months if agreed by SNH and the council).

40. The Worldwide Fund for Nature (WWF) and the RSPB initiated a judicial review of the planning consent in the Court of Session in 1998. They challenged the consent given by querying if the procedures on site designation and public consultation were correctly followed. The judicial review concluded that the planning consent was valid. The RSPB and WWF decided not to appeal against this ruling and the review was settled in October 1998.

41. HIE had hoped to start constructing the funicular in the summer of 1998 but could not do so until the judicial review concluded. Construction did not start until summer 1999.¹⁴

The HIE Board reviewed the project and approved it in 1997

42. CML, HIE and the project design team reviewed and changed the project specification between 1996 and 1997. HIE reduced the total project costs – from £16.3 million to £14.8 million – following changes to the specification of the buildings. HIE also restructured the funding package so that HIE would fund and develop the railway and associated systems with financial help from the EU. CML would develop the buildings, with financial support from HIE and the EU.

43. The 1997 business case also took account of new information and reduced the expected number of visitors in line with more recent trends. However, the business case also increased the forecast profits, based on CML adopting a more rigorous regime of cost control and management. HIE also commissioned a new study on the economic impacts of the project to take account of the other adjustments in the project and its scaling down. The estimated number of full-time equivalent (FTE) jobs likely to be created by the project was reduced from 151 to 135.

44. Because of the changes, the HIE Board reconsidered the project in 1997. The board was aware of the restrictions imposed by the visitor management plan and that the prospects for a return on the investment were low. However, significant economic impacts on the Aviemore area were also expected. Ultimately, the decision to support the funicular was a matter of judgement. The board approved the revised application on 16 September 1997 (Exhibit 6, overleaf).

45. The board attached nine conditions to its approval, including the need to secure at least £975,000 of EU funding and at least £2.5 million of bank lending on satisfactory terms (in addition to the bank's continuing overdraft of £1.5 million). HIE did not set any formal performance targets for the funicular.

The Secretary of State for Scotland set a limit on public sector funding

46. The level of public sector investment in the project required the Secretary of State for Scotland's approval.¹⁵ Having taken advice from staff within the Scottish Office, the

Secretary of State approved HIE's financial contribution of £9.39 million to the project on 14 November 1997. He stated that he attached particular weight to HIE's support for it and set three conditions. That:

- the project succeed in securing the remaining funding required to realise its financial plan
- there should be no further public sector financial contribution (from the Secretary of State, whether through HIE or otherwise) to the project, effectively imposing a limit of £12.356 million
- MBSE should exercise its right to appoint a director to the board of CML.¹⁶

Tendering for the project was delayed while HIE waited for formal approval of EU funding

47. In September 1997, HIE, MBSE and CML applied for European Regional Development Funding (ERDF) of £2.966 million for the funicular project. Following a separate appraisal process, the monitoring committee of the Highlands and Islands Partnership Programme (HIPP) approved funding of £2.699 million in December 1997 on behalf of the Secretary of State for Scotland.¹⁷

48. HIE could not start the construction work until it had received the EU's formal approval of the funding. However, approval was delayed until May 1999, firstly by the judicial review and then while HIE and the EU negotiated the terms and conditions of the award.

¹⁴ HIE still needed to receive formal approval of the EU's funding and this led to delays in tendering for the project.

¹⁵ HIE's delegated authority was £500,000 for an individual project at this time.

¹⁶ A director was not appointed until 2004. HIE wrote to the Scottish Executive in April 2001 explaining that it would be difficult to find someone willing to take on the position given CML's financial position and that other arrangements provided a good link with CML.

¹⁷ Insufficient funding remained in Scotland's ERDF allocation to cover the full amount requested.

Exhibit 6

The funicular proposal approved by HIE in September 1997

Summary

Total cost = £14.831 million. Project to be completed by 2001.

Finance

Sources of funding:

Bank loan	£2.475 million
EU	£2.966 million
HIE/MBSE	£9.390 million (includes £450,000 as preference shares)
Total	£14.831 million

The total cost of the buildings was £4.875 million.

The HIE network would fund 29 per cent of the building construction costs (£1.425 million) and the EU would fund 20 per cent (£975,000).

The total cost of the funicular and engineering works was £9.956 million.

HIE would fund 80 per cent (£7.965 million) of the cost of installing the funicular and the engineering works and the EU would fund the remaining 20 per cent (£1.991 million).

CML would lease the funicular at an annual base rent of £300,000 plus a variable element based on turnover.

Expected benefits

HIE expected that the funicular would benefit the area by:

- helping to strengthen the economic base of the area
- encouraging others to invest in the area
- providing more secure employment at CML
- improving the appeal of the area as a tourist destination
- improving the controlled use of the area to minimise environmental impacts.

CML was expected to benefit through:

- becoming less reliant on winter income
- increased capacity for skiers
- reduced queuing during periods of peak demand
- investment to replace its ageing chairlifts
- offering a more appealing and reliable service that catered for a wider range of customers.

Visitor numbers

Expected number of skiers each year was: 186,400 from 1997-2000 and 200,000 from 2001 onwards.

Expected number of non-skiing visitors was: 50,000 from 1997-2000 and 165,000 from 2001 onwards.

The business case also looked at the prospects for the project if visitor numbers were ten per cent above and below these base figures.

Other assumptions

The funicular was expected to close for five days each year due to high winds.

Profitability

- Forecast based on the base level case described above.
- CML's projected annual profit (after tax):

1998	£258,000
1999	£297,000
2000	£226,000
2001	£362,000
2002	£336,000
2003	£415,000
2004	£491,000

Employment impact

- The net impact on employment levels within the HIE area was estimated as 135 FTE jobs, including 19.5 FTE construction jobs.
- The net grant equivalent cost per job was £11,000.

49. The offer of EU funding had a number of conditions, of which three had important implications for the future development and operation of the funicular. They were that:

- HIE must let all contracts relating to the project by December 1999 and all construction work must be completed by December 2001
- the funicular must operate for a period of 25 years from commencement with no change of purpose allowed
- the closed system must be permanently operated.

50. HIE would have to repay the entire grant if these conditions were breached. The EU conditions also allowed for some of the funding to be clawed back if fewer than 105 jobs were created or retained within three and eight years of the funicular starting to operate. The EU set audit dates in July 2002 and July 2007.

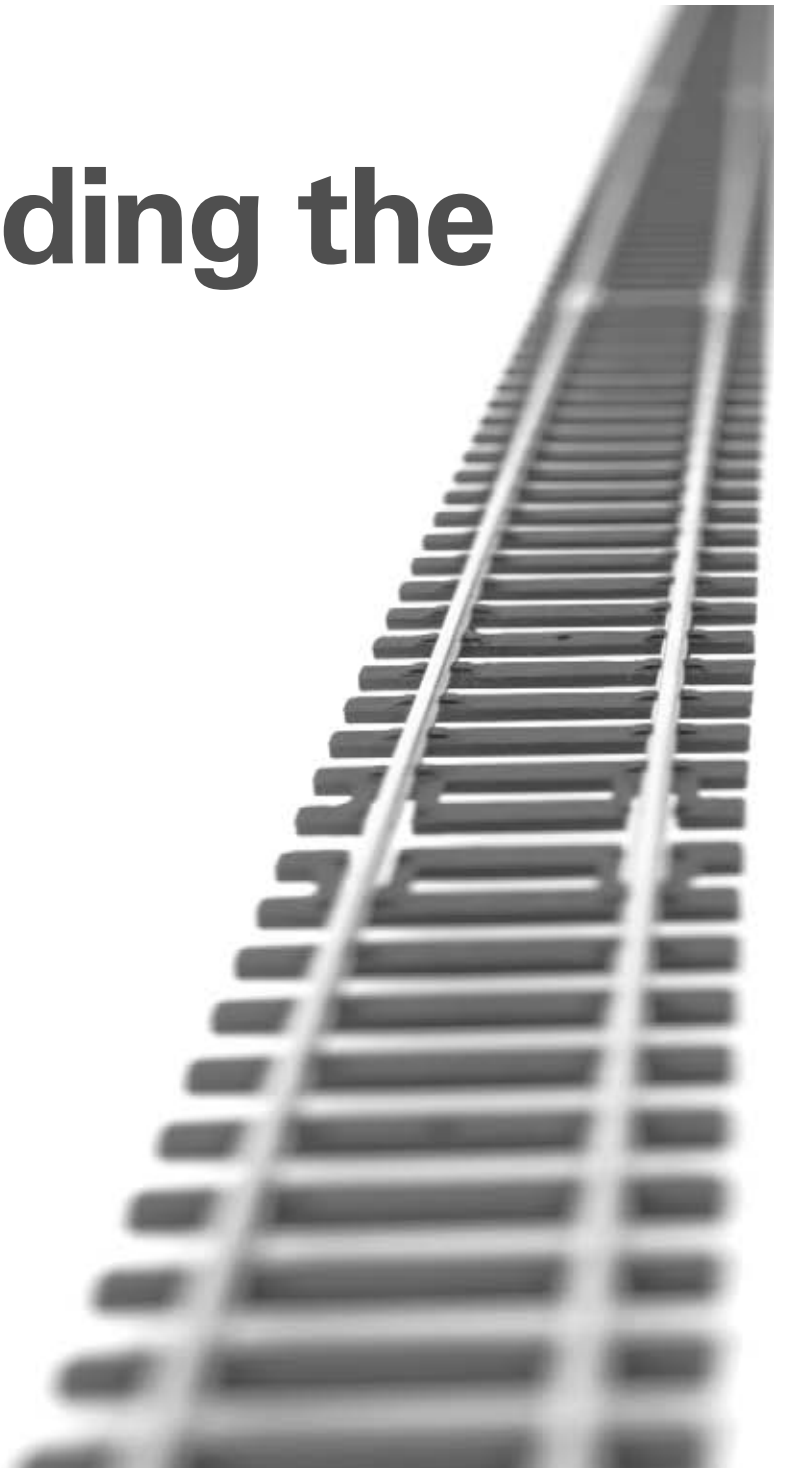
Recommendations

A review of HIE's project appraisal manual shows that HIE has improved its procedures for managing major projects. HIE's current Project Appraisal Training Manual requires that:

- projects clearly contribute to helping HIE to meet its objectives as laid out in the operating plan and to delivering the government's economic plan
- the senior responsible officer provides a strategic steer and ensures the programme/project provides good value for money
- project appraisals explain the strategic relevance of the proposed project, the particular strategic aims and objectives to which it will contribute and how it is expected to contribute to them
- option appraisals are carried out with options weighted and scored to assess their relative merits
- risk and benefit analysis tools are used; and risk registers and risk action plans are developed to mitigate risks where they are thought to be complex or severe.

HIE should continue to use these approaches and ensure that it reviews and updates its project appraisal processes with emerging good practice.

Part 2. Building the funicular



HIE did not review and adjust the business case to take account of the changing situation before construction started.



Key messages

- HIE tried to control costs but the budget proved unrealistic.
- The focus on project design and controlling costs appears to have drawn attention away from other important changes, affecting the assumptions and short and long-term viability of the project and the operator.
- HIE did not review and adjust the business case to take account of the changing situation before construction started.

In 1997, HIE set a budget of £14.6 million for the funicular

51. CML appointed Turner and Townsend to act as project managers. HIE identified a senior manager in its property team to work with the project managers. Turner and Townsend's quantity surveyors helped set detailed budgets for different elements of the project, based on a total project cost of £14.831 million. However, because the EU funding award was £267,000 lower than expected, HIE set a target cost of £14.612 million. HIE believed that the target cost could be achieved from savings after the contract tendering, and by using extra funding of £47,800 from the bank, if needed.

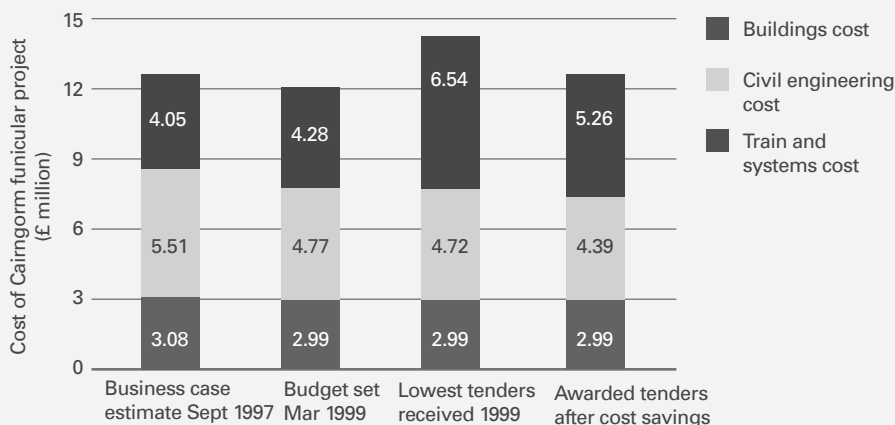
Tenders were higher than anticipated and HIE changed the specification to meet the budget

52. HIE divided the project into three main contracts: for the train and systems; buildings; and the civil engineering works. Turner and Townsend carried out the tender appraisal and negotiated with the tenderers on price and approach. The successful tenderers were formally appointed by HIE's Director of Strategy based on a recommendation from Turner and Townsend and agreed

Exhibit 7

Budgets compared with tender costs

HIE changed the specification to reduce costs when the building tenders were higher than expected.



Note: Professional fees and electricity installation are excluded from this chart. In September 1997, the estimated cost of these elements was £1.966 million. Not all of the professional services used had individual budgets set for them or were tendered.

Source: Audit Scotland from HIE's business case 1997/Turner and Townsend's tender evaluation reports

by HIE's senior property manager. Having given approval for the funding in 1997, neither the HIE Board nor the management group was involved in appointing the contractors.

53. HIE used a competitive tendering process and followed its established contracting procedures. In 2003/04, the EU reviewed HIE's procurement procedures for the Cairngorm funicular. After lengthy negotiations, the Scottish Government accepted the EU auditor's decision that HIE did not follow some aspects of the EU's procurement procedures. The EU found that HIE had not:

- identified in its tender documentation all the criteria to be used or detailed the weighting for the criteria
- followed the correct procedure when it used contractors' experience as a criterion in the final stages of the competition.

54. As a result, the Scottish Government agreed to repay £85,989 to the EU.

55. Turner and Townsend issued the invitations to tender for two of the contracts (the civil engineering works and the train and systems) in May 1999. The process to identify prospective contractors for the buildings began in June 1999.

56. The project managers received seven tenders for the civil engineering works on 15 June 1999 and, after evaluating them, recommended that Morrison Construction Limited (Morrison's) be awarded the contract. The tendered cost, at £4.724 million, was £46,000 less than the budget set (£4.77 million) for this element of the work. The contract was awarded on 7 July and construction started on 9 August 1999.

57. Four companies submitted bids for the trains and systems contract and Dopplemayr Tramways Ltd (DTL) was appointed on 27 August 1999. DTL's bid was £2.993 million, which was in line with the budget set for this element of the work.

58. The last contract awarded was for the buildings. On 19 November 1999, HIE received tenders for the buildings

from three contractors, which were priced at between £6.5 million and £7.5 million. All exceeded the £4.28 million budget by a large margin (Exhibit 7, page 15). HIE asked all three tenderers to find savings to meet its budget but only one, Morrisons, fully accepted this request.¹⁸ Following advice from the project managers, HIE then entered into negotiations with Morrisons for a combined tender for the civil engineering works and the buildings.

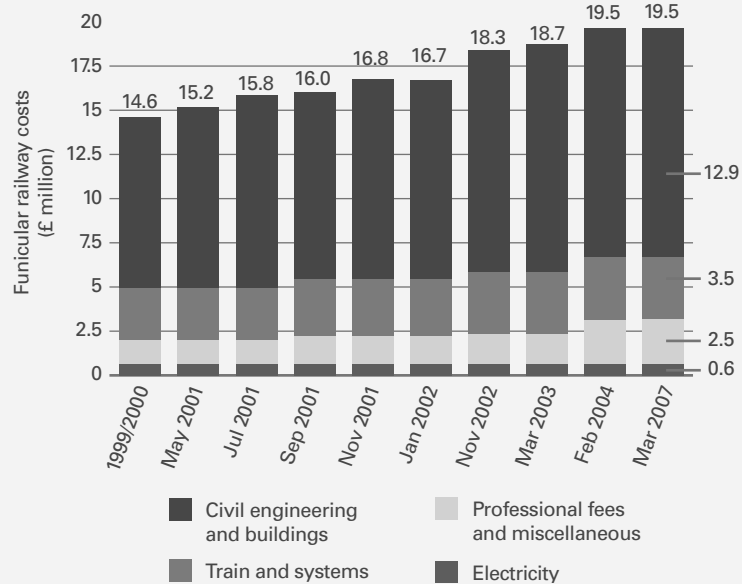
59. HIE agreed to changes to the project specification to reduce costs and stay within the budget of £14.6 million (Appendix 1). The combined bid from Morrisons offered overall savings of £1.4 million against its original cost. Morrisons reduced the cost of the civil engineering work by £500,000 by, for example, changing the tunnel design and excavation method. They identified further general savings of £300,000 and savings of £545,000 from the design of the bottom and top stations. Some elements, such as installing a goods lift in the bottom station and removing the existing chairlifts, were excluded from the tender, giving a saving of £100,000. Other elements were respecified, for example, Morrisons proposed using less expensive finishes internally and externally.

60. The negotiations with Morrisons took place between 19 November and 21 December 1999, and were completed just a few days before the deadline set by the EU funding conditions. In December 1999, HIE issued a letter of intent for the combined contract to Morrisons, pending final agreement of the contract documentation and verification of the contract amount of £9.332 million. (The 1999 budget figure was £9.05 million for these two elements).

Exhibit 8

Timeline of cost increases for the project

Costs increased from £14.6 million to £19.5 million between 1999 and 2007.



HIE tried to manage increasing costs but budgets proved to be unrealistic

61. On 25 May 2000, after detailed design work and value engineering was complete, Morrisons indicated that only £1.1 million of savings were possible through the combined contract. Turner and Townsend reviewed Morrisons' revised tender and issued their recommendation to appoint Morrisons on 8 June 2000. On 15 June 2000, HIE wrote to Morrisons formally accepting the revised bid of £9.643 million for the combined tender. Morrisons accepted the contract, after further negotiation, on 21 August 2000.

62. HIE could only fund this increased cost by changing the specification again (this time dropping the proposed installation of ticketing arrangements in the car park) and reducing its budget contingency to a very low level. The Secretary of State's condition restricted further contributions from the public sector

and the private sector had proven unwilling to invest in the past.¹⁹ HIE did not try to identify funding from other sources at this time.

63. As work progressed, Morrisons notified the project managers that they were incurring additional expenditure due to the complexity of the project and the need to find ways to limit damage to the mountains. For example, the contractors transported materials across the site by helicopter because surface transport would cause too much damage. The first indication of higher costs was provided by Turner and Townsend in May 2001, when it estimated that total costs had increased to £15.2 million (four per cent over the target cost of £14.6 million). The HIE Board first discussed the issue in June 2001.

64. Other cost increases followed and these were subject to detailed review by HIE, including asking for legal advice (Exhibit 8). Audit Scotland's 2003/04 audit report concluded that HIE took all reasonable steps to

¹⁸ One tenderer declined to reconsider its tender and another did not provide written confirmation of possible savings.

¹⁹ Only the bank was willing to offer funding of £2.523 million.

control costs, and recommended that, in future, more time is allowed at the preliminary and design stages to develop realistic budget costs before submitting these to the HIE Board.²⁰

65. HIE and its advisers had set the budget without the benefit of experience of similar types of construction projects. The funicular project had a number of challenges, many of which had not previously been experienced in Scotland. For example, the funicular was the first such facility in the country. It was built in a remote area, at high altitude, to exacting standards to protect the environment and within a narrow timeframe. This made it difficult to accurately predict costs.

66. In December 2001, HIE revised the application for the EU funding after HIE also agreed to pay for the construction of the buildings.²¹ The revised application still showed the total cost of the project to be £14.8 million.

67. HIE made the final payment for the construction work in March 2007. The total cost had increased to £19.54 million (£4.9 million – 34 per cent – over the 1997 target cost).

HIE's planned contingency was too low for a project of this scale

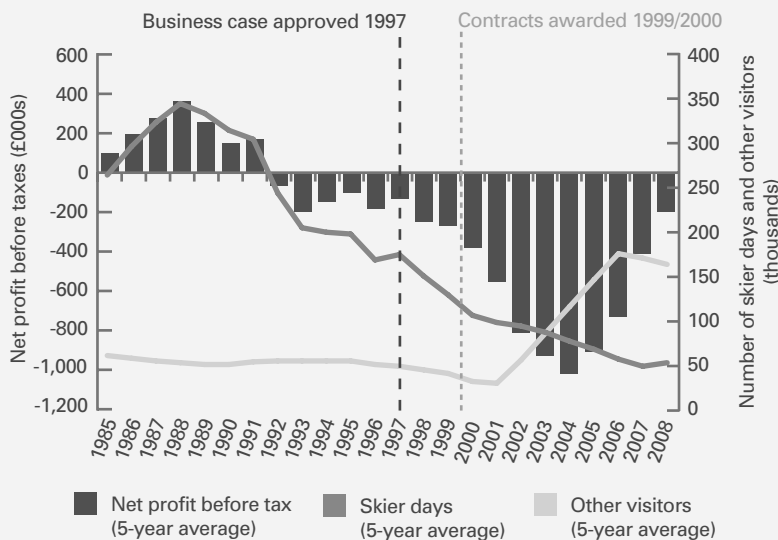
68. The initial business case estimate included a contingency of £645,000. However, the higher buildings costs resulted in HIE reducing the contingency element to £7,667 (0.05 per cent of the budget). HIE's internal auditors reviewed the project in 2002 and stated that the contingency included in the budget was not realistic.

69. HIE recognised this in its progress report on the funicular, prepared for the HIE Board meeting of November 2001. This stated that a contingency

Exhibit 9

CML financial performance and visitor numbers

Falling visitor numbers affected CML's long-term viability.



Source: Audit Scotland

figure of at least 15 per cent of the contract value (£2 million in this case) was standard.

70. The low level of contingency placed HIE under increased pressure to control costs to keep within the £14.6 million funding available for the project. In 2000, Turner and Townsend had reported that 'there is a likelihood of further additional variations/ expenditure on the construction works'. They concluded it would be necessary 'to achieve further cost reductions if the final out-turn figure is to be kept within budget'.²²

HIE's chief executive moved to one of the contractors

71. HIE's chief executive left HIE in September 2000 to take up a post with Morrison plc, as Director for Corporate Development. He announced his intention to leave in July 2000. The announcement led to concerns in the public and media about the probity of aspects of the funicular process. Media coverage at

the time also noted that the previous chair of HIE had been, and remained, the executive chair of Morrison plc. In response to the concerns, the then Minister for Enterprise and Lifelong Learning requested that the chair of HIE investigate the matter. The chair subsequently provided the minister with assurances about the process.

72. We established that Sir Fraser Morrison, chair of HIE, was present at board meetings in 1996 and 1997 when the funicular project was discussed. At this stage, Morrison plc had no involvement in the funicular project and the chair's participation was in accordance with HIE's procedures. The chair left HIE in 1998, before any of the tenders had been let, or contracts awarded.

73. We understand that HIE's chief executive was approached by Morrison plc in June 2000. The chief executive wrote to HIE's Head of Property on 19 July, stating that all property matters should be referred to the Director of Growing Businesses at

²⁰ Highlands and Islands Enterprise. Report on the 2003/04 audit, Audit Scotland, November 2004.

²¹ More detail is provided at paragraphs 84-87.

²² Cairngorm Mountain Railway Combined tender for lots 2 and 3, final tender report, Turner and Townsend, 8 June 2000.

HIE, with immediate effect. The chief executive announced his resignation formally on 20 July. An approach in June 2000 would have been almost three years after the initial appraisal and approval process and, in relation to this aspect of the process, there would have been no potential conflict of interest. In June 2000, HIE was in negotiations with Morrison plc about the remaining contract. The minutes of HIE's management team and board indicate that neither group was considering the funicular at that time. HIE has indicated that the chief executive had no direct involvement in the funicular project or contracts at that stage.

HIE did not review the business case to take account of the changing situation before construction started

74. The HIE Board had made EU funding a condition of its approval, so the project could only proceed if the contracts were let by the ERDF deadline, or if the HIE Board was willing to abandon this condition. Because the EU conditions required all contracts to be let by December 1999 and all construction work to be completed by December 2001, HIE was under pressure to proceed quickly with the project.

75. HIE focused on the project design and controlling costs, but there were other changes affecting the viability of the project. In particular:

- The number of skiers continued to decline, both at Cairngorm and across Scotland. In 1997, 97,000 skiers used Cairngorm but this fell to 75,000 in 1998 (Exhibit 4 and 9, pages 8 and 17). The business case had assumed 186,000 ski visitors per year.

- CML was struggling financially. In 1997 and 1998, CML reported losses of £607,000 and £625,000 respectively (representing 33 per cent and 48 per cent of its annual turnover). HIE completed an internal audit of the funicular project in 2002, which reported the auditor's concern about the accuracy of a statement contained in a letter sent by HIE to the EU in 1999. In the letter, HIE confirmed that CML was 'at present in a sound position.' The internal audit report states that, at the time, CML's management accounts showed net current assets of £327,000 and net current liabilities of £1.743 million.

76. HIE did not review or adjust the business case before construction started. Audit Scotland's *Review of major capital projects* found that this is an area for improvement in how projects are managed by public bodies in Scotland. Good practice in project management would now include regular review of the business case throughout the project lifecycle, to ensure that any changes affecting the project are justified and provide value for money, and to help reinforce proper reporting and accountability.²³

Recommendations

HIE's current Project Appraisal Training Manual requires that:

- project briefs and appraisal and implementation papers are prepared for all projects and provide sufficient information on the need for the project and proposed method of delivery to allow an informed decision to be made
- project managers plan the implementation of the project, including the resource requirements, and agree the acceptable level of flexibility in the project scope, timescale and outputs with the senior responsible officer
- there is independent review of the project.

HIE should continue to use these approaches and ensure that it reviews and updates its project appraisal processes with emerging good practice.

Part 3. Securing the benefits of the funicular



The funicular cost much more than anticipated but consultants report that it has delivered the anticipated benefits.



Key messages

- The public sector has invested £23 million in the funicular and operator.
- Consultants report that the funicular has delivered anticipated employment and wider benefits to the Strathspey area.
- Some of the business case assumptions proved inaccurate and not all of the anticipated outcomes have been realised.
- HIE provided extensive support both to the funicular project and to the operator to try to deliver the anticipated benefits.
- Some of HIE's actions between 2001 and 2008 were effective in the short term but did not resolve CML's problems.
- HIE took CML into public ownership in 2008 and secured full control over the assets and the operation.
- HIE is working with CML to develop a new business model for the funicular.

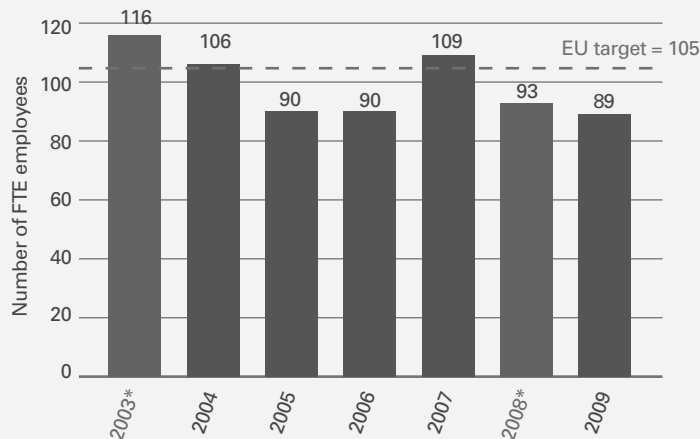
The project has delivered benefits but not all of the expected outcomes

77. HIE saw the funicular as a strategic priority for the region and has invested significant time, money and effort in the project to try to ensure it delivers the benefits anticipated in the business case. The overall aim of the project was to provide a suitable uplift system to the top of Cairngorm and a visitor attraction with year-round appeal that, along with the development of Aviemore Highland Resort and the Cairngorm National Park, would act as a catalyst for the redevelopment of the wider Strathspey area.²⁴

Exhibit 10

Employment at CML

CML met the EU target of 105 jobs in July 2002.



Note: Years are financial year to 30 April for 2003–08, and 11 months to 29 March 2009. The July 2002 and 2007 figures are shown in the 2003 and 2008 results, marked with *. Figures represent the average monthly number of employees over the year.

Source: Audit Scotland/CML

78. The funicular transports visitors on the mountain all year round. A consultants' report in 2006 on the economic impact of the funicular found that the wider economic benefits have been realised. These benefits include:

- Significant new investment in the Aviemore area. The Aviemore Highland Resort opened in 2004, providing a hotel, exhibition hall, ballroom and 650-seat auditorium. The Cairngorm National Park was established in 2003.
- The creation of a year-round operation at CML providing continuous employment for staff. Of the 89 staff (full-time equivalent) currently employed at CML, only 27 (30 per cent) are seasonal staff. The business case shows that, in 1997, 45 per cent of employees were seasonal staff. The consultants also report that CML is providing a range of employment opportunities, including managerial and professional jobs, and that staff are relatively well paid for the sector.
- Greater use of the area by tourists. We compared the 2005 occupancy

rates of rooms and beds at hotels, guesthouses and B&Bs with previous years, and against the average for the Highlands and Islands, and found that the rates have improved.

- The funicular is an important facility within the Cairngorm National Park and offers a wide range of opportunities for summer and winter activity. Although Badenoch and Strathspey has many visitor attractions, the funicular has attracted more paying visitors (excluding skiers) than any of the other attractions (such as the Landmark Forest Theme Park, local distilleries, museums and wildlife centres) each year since it opened.

79. The only specific target was the one set by the EU – that the funicular should employ at least 105 people on a full-time equivalent basis in July 2002 and 2007. The EU conducted an audit in July 2002, when CML met the target. However, the EU did not repeat the audit in July 2007. The information provided to us by CML suggests that the target was not met in 2007 (Exhibit 10).

²⁴ The business case predicted wider benefits through the funicular's 'catalytic role in the redevelopment of Aviemore and Strathspey...attracting the private sector to invest in other facilities' and 'maintaining and improving the attraction of Scotland as a tourist destination in an increasingly competitive international market'. Cairngorm funicular business case, HIE, 1997.

80. Although there were no other targets, the business case set out a range of expected outcomes. The funicular has achieved some, but not all, of these. Some of the business case assumptions have proven to be inaccurate (Exhibit 11).

81. There are a number of important points to note in relation to the outcomes and assumptions:

- Use by skiers is well below the anticipated level, averaging between 30-55 per cent of the forecast total. However, the fall in skier numbers at Cairngorm is in line with wider trends across Scotland (Exhibit 4, page 8).

Exhibit 11

Comparison of outcomes against key aspects of the business case

Assumptions and expectations	Business case	Outcomes	Within HIE's control?	Achieved/met?
Main objectives				
	To deliver a funicular railway to serve as an uplift system for visitors to the mountain	Funicular system in place	Yes	Yes
	To provide a year-round visitor attraction	Funicular is used all year round	Yes	Yes
Finance				
Total cost	£14.8 million	£19.54 million	No	No
Public sector contribution	£12.3 million	£19.54 million	Partly	No
– HIE contribution	– £9.390 million	– £16.93 million	Yes	Yes
– EU contribution	– £2.966 million	– £2.61 million	No	Partly
Bank contribution	£2.475 million	£0	No	No
Rent to be paid by CML to HIE	£300,000 per year (minimum)	Rent of £413,000 owed at takeover	Partly	No
Expected benefits (HIE)				
Project benefits of interest to HIE:	• Help strengthen the economic base of the area	• Not known (no clear measure)	Partly	Not known
	• Encourage others to invest in the area	• There has been significant investment in the area but attribution difficult	Partly	Yes
	• Provide more secure employment at CML	• More staff employed on year-round basis	Partly	Yes
	• Improve the appeal of the area as a tourist destination	• Occupancy rates in the area, when compared with the Highlands and Islands more widely, have improved	Partly	Yes
	• Improve the controlled use of the area to minimise environmental impacts	• Closed system restricts access	Partly	Yes

Continued overleaf

Assumptions and expectations	Business case	Outcomes	Within HIE's control?	Achieved/met?
Expected benefits (CML)				
CML would benefit through:	• becoming less reliant on winter income	• less reliant but significant decrease in ski visitors	No	Yes
	• increased capacity for skiers	• funicular can carry more passengers than previous chairlifts but significant decrease in ski visitors	Yes	Yes
	• reduced queuing during periods of peak demand	• visitor surveys record dissatisfaction with queues on days with snow but no initial baseline against which to measure change	No	Not known
	• replacing its ageing chairlifts	• chairlifts have been replaced	Yes	Yes
	• offering a more appealing and reliable service that catered for a wider range of customers	• greater use in summer than previous chairlifts by different user groups; funicular more reliable in adverse weather conditions	Partly	Yes
Visitor numbers (base level case)				
Ski visitors 1997-2000	186,400	94,250	No	No
Ski visitors 2001 onwards	200,000	62,250	No	No
Non-ski visitors 1997-2000	50,000	36,750	No	No
Non-ski visitors 2001 onwards	165,000	165,000	No	Yes
Other assumptions				
Days closed due to high winds	5	19	No	No
Profitability				
Forecast based on the base level case described above	Profits forecast for every year from 1998 to 2004 – average profit of approximately £340,000	Losses reported for every year from 1998 to 2004 – average loss of approximately £834,000	Partly	No
Employment impact				
Net impact on employment in HIE area ¹	115.5 FTE ¹	174.5 FTE ²	Partly	Yes
Net grant equivalent cost per job	£11,000	Not available	Partly	Not known

Note: Assessment of wider benefits and employment impact is based on the findings of consultants in 2006.

1. Figures include direct jobs, indirect jobs, induced jobs and off-site employment. Direct jobs are those created at CML. Indirect jobs result from CML's expenditure on supplies and services. Induced employment is created by CML employee spending and off-site employment by the wider spend of visitors attracted to the area by the Cairngorm facilities.

2. The initial business case anticipated 135 jobs but recognised that 19.5 of these would be related to construction. These were not included in the figure that informs the outcomes column above, and so have been excluded from the business case figure to provide a fair comparison.

Source: Audit Scotland

- Use by non-skiing visitors has been broadly on target in recent years. However, it is not clear whether the business case forecasts allowed for concessions, which accounted for 12 per cent of visitors in 2005. It is possible that the predicted income from non-skiing visitors in the business case may have been overstated.
- Overall, the funicular is not operating at capacity. In the year to March 2009 it operated at 33 per cent of its capacity. The funicular can seat 50-60 people per trip in the summer, but this increases to 120 per trip in the winter, when CML removes the seats. In the 2008/09 skiing season, it operated at 18 per cent of capacity on days when skiing was possible, although this increased to 53 per cent during the summer season.
- The public sector funded the entire cost of building the funicular. HIE paid £16.93 million (87 per cent) of the total building cost of £19.54 million. In addition, HIE bought the existing buildings at a cost of £525,000 in 2001 and the council gave £1 million to complete the exhibition centre.

HIE provided extensive support to the project and the operator

82. HIE provided extensive support to the project before and during construction, in terms of developing the business case and managing the construction phase. However, the operational stability of the operator, CML, was also critical to the success of the project.

83. CML struggled financially before and during the construction phase and, by early 2001, HIE was aware of the full extent of CML's financial difficulties. The business case had projected a total profit (after tax) for CML of £885,000 for 1999 to 2001. However, the delays in starting construction, lack of snow cover and falling numbers of winter and summer visitors all contributed to CML

recording pre-tax losses totalling £1.55 million in this period.

84. In 2001, to secure the ongoing operation of the skiing facilities, HIE commissioned consultants (KPMG) to appraise CML's likely financial position when the funicular would open at the end of 2001. HIE asked the consultants to identify actions that CML, HIE and MBSE might take to address the difficulties.

85. KPMG reported that CML was 'substantially insolvent' and, to survive its current difficulties, would require additional funding of around £3.5 million – the bank and HIE were identified as the most likely sources for funding. Based on KPMG's report, the HIE Board considered four options. HIE could:

- do nothing – effectively allowing CML to declare itself insolvent. This would allow HIE to seek a new operator with the bank's agreement. However, this may have been difficult to achieve and, if no operator was found, HIE would potentially have to reinstate the site.
- provide further funding – this was deemed difficult without breaching EU competition rules.
- defer collecting CML's contribution to the building costs – HIE, as lead contractor during construction, was due to bill CML for work on the buildings element. At the time of KPMG's review HIE had not yet billed CML for £1 million of work completed and was due to bill another £2.1 million in a few months' time. KPMG identified several weaknesses with this approach, including the fact that it may not be sufficient to ensure the long-term survival of the company.
- take ownership of all the funicular assets – HIE already owned the land and was wholly funding the installation of the train and systems. Under this option HIE would acquire the buildings and

charge CML a commercial rent for them. The HIE Board was told that this option would provide CML with a reasonable chance of re-establishing profitable trading.

86. The HIE Board established a subgroup to consider the options and commissioned KPMG to undertake further work on the forecasts and establish the number of visitors CML needed to break even. The subgroup comprised HIE's chair and chief executive, two other board members and members of the executive team. KPMG predicted that CML would be balance sheet insolvent until April 2005 and potentially for some time thereafter (although the consultants did not produce forecasts for this later period). The board asked HIE to develop a survival and recovery plan, prepare an exit strategy and make sure that the facility was properly marketed as a first-class visitor attraction. To help CML financially, the board recommended that HIE should take ownership of the buildings and lease them to CML. HIE concluded that this support was justified, based on the importance of the visitor attraction in the area, and that this would assure the project's completion and implementation on a sound basis.

HIE, the Highland Council and the bank provided additional financial support to CML

87. HIE sought permission from the Scottish Executive to increase its investment by £3.5 million. The Scottish Executive agreed to this in a letter sent on 22 August 2001, stating that 'the decision on whether to invest an additional £3.5 million in the project must be for the (HIE) board to take in light of a thorough appraisal of the options'. This meant that the Secretary of State's limit on funding from HIE no longer applied. HIE bought the five existing buildings from CML for £525,000 and became responsible for the development costs of the new buildings, at an additional cost of just over £3 million. HIE became sole owners of all the assets on the site, with CML as the tenant.

88. In May 2001, the Highland Council agreed to provide CML with a loan of £1 million to fit out its exhibition centre. This replaced planned investment described as either from CML's cash flow or by a third party. Although the exhibition centre was a key element of the project in the business case, the fixtures and fittings were not part of the funicular contract. HIE had removed this element from the budget when reducing costs.

89. The bank also increased its support for the project in 2001 by offering CML an increased overdraft facility of up to £2 million. CML had also received a lump sum injection of £525,000 from HIE for the sale of its buildings. CML used this and its £2.5 million bank loan and £2 million overdraft to continue to operate.

HIE continued to monitor the situation and provided further support after the funicular opened

90. The funicular began operating on 24 December 2001. It was officially opened by the then Tourism Minister in June 2002.

91. HIE monitored CML closely after the funicular opened and provided further support:

- HIE completed an internal audit review on the funicular in February 2002. The report identified shortcomings and made six recommendations, all of which were accepted, with three that required immediate action:
 - HIE should follow the steps outlined in the recovery and survival plan and continue to develop the exit strategy for HIE

- an appropriate rental should be charged for the funicular and buildings, taking account of operational experience to date
- adequate arrangements be put in place for project monitoring and any necessary continued support to CML.

- HIE commissioned two marketing audits in 2002 and 2003, which concluded that CML needed to develop its local marketing activity and partnerships and focus more strongly on the needs of non-skiers. CML improved its marketing of the facility by, for example, organising the directional signage to the facility from the A9 road and taking advantage of the public relations opportunity of the opening of the Cairngorm National Park by acting as the host venue. Since opening, CML has widened its visitor offer by adding a mountain garden, a camera obscura and an arts project.

- In September 2003, HIE completed a gateway review of its investment in the funicular, to identify the short and medium-term actions needed and to help develop the exit strategy. The report recommended that HIE must first be clear about what it is trying to achieve with CML and then consider all of the options in a clear and objective manner before deciding on a course of action. HIE decided to support CML to establish a profitable business and worked with CML's creditors to achieve this.

HIE's support was effective in the short term but has not yet provided a long-term solution

92. CML's financial difficulties continued and it reported losses of £1.875 million in the year to April 2002 and £1.209 million to April 2003. HIE provided further support by agreeing to defer rents from February 2003 onwards to prevent CML exhausting its credit facilities. Although this action helped reduce the deficit, CML reported a further loss of £576,000 in 2004.

93. In 2004, HIE obtained professional advice from property consultants and agreed to reduce the base rent from £513,000 per year to £100,000 per year and increase the level of turnover at which rent increases became payable.²⁵ HIE converted the outstanding rent of £585,000 to a loan on 23 March 2004, to be paid over ten years with interest of 5.75 per cent. At the same time, the bank extended CML's overdraft for another 12 months and reduced its interest rate on the loan from one per cent above base rate to one per cent. The council also set a rate of one per cent on its loan.

94. Initially these changes had a positive effect. CML reported a small loss of £36,000 in the year to April 2005 and a small profit of £32,000 in April 2006. However, 2006/07 was another poor year for ski visitors and CML reported a loss of £262,500.

HIE took CML into public ownership in May 2008

95. The HIE Board considered three options for further support of CML at its August 2007 meeting:

- invest a further £1.7 million to support CML and seek a further £7-10 million for capital investment in the facility to attract more non-skiing visitors

²⁵ Initially, there were two elements to the rent. A fixed yearly amount of £513,500 (£300,000 for the railway and infrastructure, £135,000 for the new buildings and £78,500 for the existing buildings) and a turnover-based rent set at 18.3 per cent of turnover above £3 million, but less than £6 million. The maximum potential rent was £1,062,500 but the variable rental element was never due as turnover did not reach the threshold. HIE reduced the rent in 2004 to £100,000 and set a threshold of £3.38 million for incremental rent, on the basis that the previous rates were no longer appropriate to the operating and market conditions.

- allow CML to go into receivership. HIE's potential loss was calculated as £880,000
- purchase the bank's security over the asset at a discount and install a new operator. The estimated cost of this was £1.5 to £2.1 million.²⁶

96. The board agreed that, to protect the assets, operation of the facilities and HIE's investment, HIE should purchase the bank's security and it set a budget for this. Doing this would give HIE full control of the asset and allow it to develop a new business model for the funicular.

97. It took some time to reach agreement with the bank on the cost, partly due to CML's better performance in 2008 – in the year to April 2008, CML reported a profit of £173,500, aided by a long skiing season and good snow cover.

98. HIE also negotiated with the council and the Cairngorm Trust (owners of CML) to buy their outstanding loans to CML. HIE took CML into public ownership on 16 May 2008. HIE bought the Highland Council's £1 million loan for £1 and bought the Cairngorm Trust's loan of £101,312 for £1. HIE bought the bank's security and the bank wrote off CML's outstanding debt.²⁷ At this time, HIE was owed a dividend of £216,000 for its preference shares and £413,000 for unpaid rent.

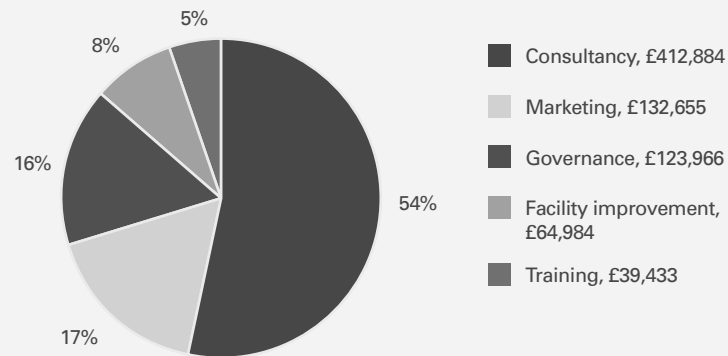
99. The funicular and buildings are currently valued at £232,000. For reasons of commercial confidentiality we are not able to publish the amount HIE paid to acquire the assets.

100. In addition to direct support for the funicular, MBSE and HIE provided financial assistance to CML for a variety of other purposes. Since taking CML over, the HIE Board has approved up to £760,000 as working

Exhibit 12

Other assistance provided to CML

HIE provided CML with £774,000 to help with consultancy, marketing and other costs.



Source: Data provided by HIE

capital for CML and, from 1997 to June 2009, CML received £774,000 in assistance to help with governance, consultancy, marketing, facility improvement and training initiatives (Exhibit 12).²⁸

HIE is working with CML to develop a new business model

101. From May 2008, HIE has worked with the company to develop action and risk management plans and to deal with a number of other operational issues, such as recruiting new directors and progressing health and safety and maintenance work. HIE and CML have also agreed an annual budget and business plan and finalised an operating agreement setting out the required governance standards.

102. CML's draft accounts for the 11-month period ending 29 March 2009 show a loss of £42,728 (before tax).

103. In December 2008, HIE commissioned consultants to report on the robustness of the current CML business model and to recommend a future model. The consultants'

report was due in March 2009 but the final version was delayed until September 2009. At the time of writing this report, we had not seen the consultants' report. The HIE Board will consider the options arising from the consultants' work at its meeting in December 2009.

104. HIE hopes to seek a new operator for the funicular, although this may be difficult in the current economic climate. If this proves to be the case, HIE will need to develop a plan for its continued involvement with the funicular, which takes account of current operating costs, risks and any future investment needs.

105. The planning permission granted for the funicular requires HIE to reinstate the land if the facilities do not operate for any period of 12 months (or longer if agreed by SNH and the council). In 2007, the HIE Board was informed the costs could amount to £30-50 million, however, the figures are speculative and no work has been undertaken to provide realistic estimates.

²⁶ Included within this is an allowance for acquiring the security, providing working capital and writing off loans.

²⁷ The figure paid by HIE to the bank for its security is commercially sensitive.

²⁸ The amount of working capital actually used by CML varies. At the time of writing our report, CML had used £460,000 and this figure is used in our calculations of the cost of the funicular.

106. In addition to the reinstatement costs, HIE would need to repay the EU funding of £2.6 million if the funicular ceased to operate and cover potential redundancy costs, although no estimate of these is available.

Recommendations

In developing a new business model for the funicular, HIE must learn from its experience to date. It should ensure that it:

- fully assesses and manages all the risks and constraints facing the facility
- reviews current performance against capacity
- considers likely demand from different user groups
- develops a clear set of objectives for the business, with measurable outcomes
- provides prospective operators with a detailed analysis of the challenges faced, drawing on experience to date
- considers changes in market, environmental and financial conditions
- creates a sustainable and attractive business opportunity for any new operator.

When assessing bids for the business, HIE should ensure that prospective operators:

- are aware of the current risks and make adequate provision for them
- will offer activities that have a positive impact on the surrounding area, taking account of possible displacement

- will observe any requirements in place to protect the fragile and unique environment of the area
- have developed a financially sustainable model for the business.

Appendix 1.

Description of the funicular project in 1997

The proposed scheme of work outlined in the 1997 business case involved the development of:

- a new bottom station (of 840 sq m) for the funicular railway adjacent to the existing day lodge. The new building would provide an enclosed station, platform and area for ticket sales and passenger control
- a new middle station (of 340 sq m) with concourse, platform and station area. This would be linked by covered walkway to the existing Sheiling snack bar. (The new station was later removed from the project specification to reduce costs.)
- a new top station (of 2,265 sq m) with a subterranean railway station, an exhibition centre and 250-seat restaurant. (Some of the facilities at the top station were later scaled down to reduce costs.)

These buildings would be linked by a 2 km length of railway track. The railway track enters the top station through a tunnel.

The project cost also included:

- provision of the railway carriages, motor drives, gear boxes and cabling
- concrete bases, beams and columns for the railway
- upgrades and new provision of sewage, electricity and water supply services
- landscaping and other reinstatement work.

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