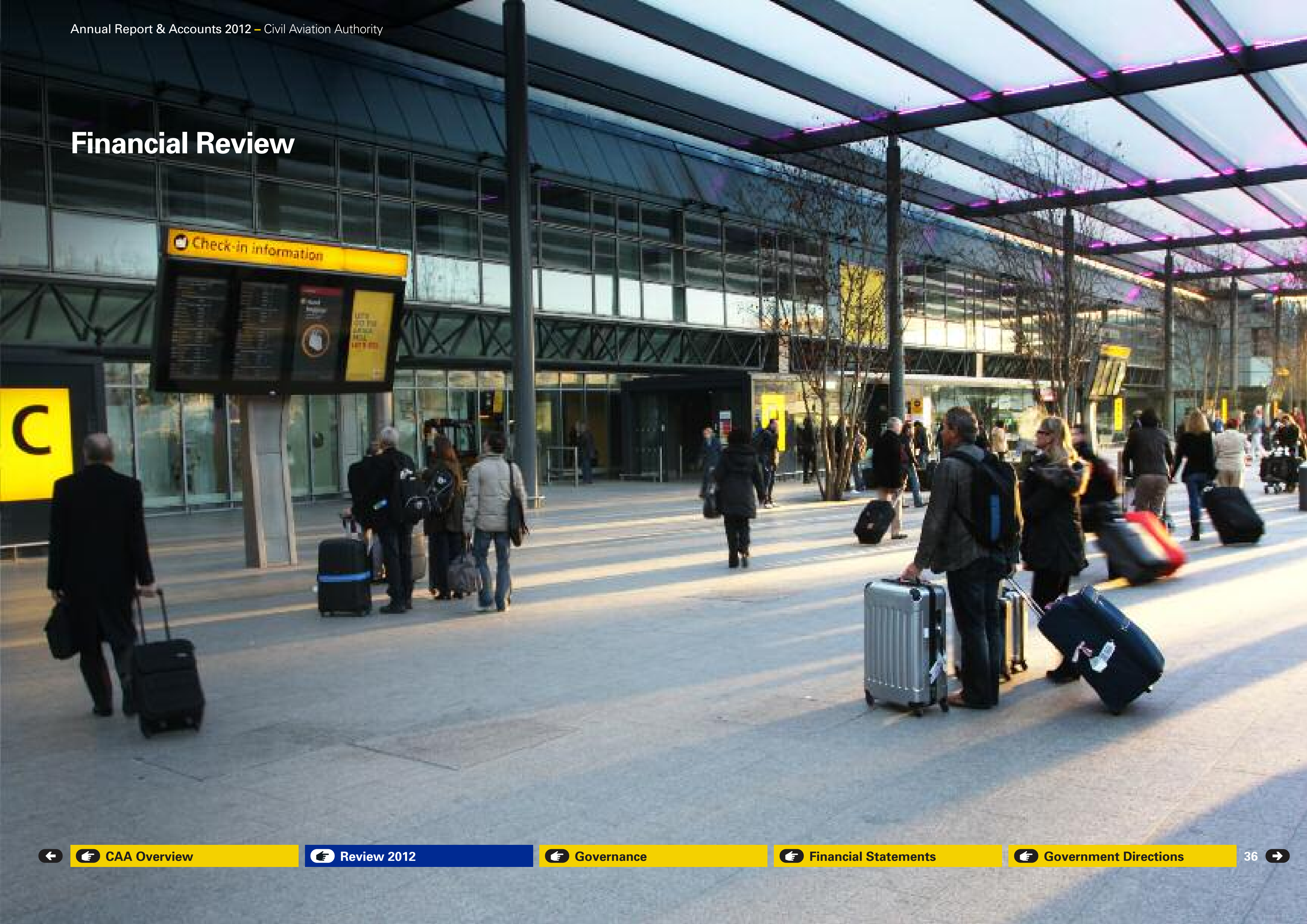
Financial Review



SIGNIFICANT FINANCIAL DEVELOPMENTS

Trading Year

The financial year ended 31 March 2012 continued to be a challenging environment for the CAA from a financial perspective, with the deteriorating global economic climate continuing to put pressure on income, which is heavily reliant on industry activity levels. Despite these pressures, the CAA achieved a rate of return of 4.2% for the regulatory sector which was marginally below the 6% target rate of return set by the Secretary of State for Transport. This result was achieved by the CAA continuing to implement cost saving measures and generating income from its commercial subsidiary, CAA International Limited (CAAi).

The CAA is directed by the DfT to prepare the financial statements in accordance with the accounting and disclosure requirements of companies' legislation currently in force and international generally accepted accounting practice. The CAA is required to comply with International Accounting Standard (IAS) 19 'Employee Benefits' for the year ended 31 March 2012. However, the financial results of the Group are assessed by reference to financial targets agreed with the Secretary of State for Transport. The Group regulatory sector target requires the CAA to set its unit charges at levels sufficient to achieve a return of 6% before interest on the average level of capital employed, expressed in current cost terms. In respect of pension costs this target is based upon the level of employer cash contributions paid to the CAA Pension Scheme during the financial year, rather than pension costs evaluated under IAS 19.

The latest formal valuation of the CAA Section of the Civil Aviation Authority Pension Scheme at 31 December 2009 was approved by the Scheme's Trustees on 31 March 2011. The valuation revealed an ongoing surplus of £99.7m, whereas the IAS 19 valuation surplus was £606.2m (note 18). The methodology underlying the formal valuation differs from that used for IAS 19 disclosures, particularly in relation to the financial assumptions used. Whilst the discount rate used for IAS 19 disclosures should be based on the yield of at least AA-rated corporate bonds, irrespective of the investment strategy actually adopted, the discount rates used for the 2009 formal valuation were largely based on Government bond (gilt) yields (which, as at 31 December 2009, were about 1.2% pa lower than corporate bond yields). This reflects the investment strategy of the Scheme where the majority of the assets (about 84% as at 31 December 2009 and, currently, about 82%) are invested in gilts as part of a strategy to match, so far as possible, the Scheme's pension liabilities by the cash flows from a portfolio of index-linked gilts. In addition, the formal valuation has a more prudent basis than IAS 19 disclosures and this is allowed for by means of further adjustments to the discount rate and the inclusion of reserves for contingent events, including further improvements in longevity.

CAA International Limited (CAAi)

The wholly owned subsidiary company, CAAi, delivered an expanded programme of technical assistance and training, supporting industry and the Government both in the UK and overseas. The company had another successful year, achieving a turnover of £15.4m (2011 - £14.5m), an annual increase of 6.3%, despite the difficult trading conditions created by a depressed global economy the company continues to expand its new customers, products and markets. The company's operating result saw a reduced profit after tax of £1.3m (2011 - £1.7m) principally reflecting the increase in employee costs during the year. The company employed an average of 33 staff during the financial year with a further 42 being supplied from other areas within the Group.

Air Safety Support International Limited (ASSI)

ASSI is a wholly owned subsidiary company that was set up at the request of the Department for Transport (DfT). The company's principal business activity, under Direction from the Secretary of State for Transport, is the enhancement of regulatory oversight of aviation safety in the UK's Overseas Territories (OT).

The company does not trade with a view to a profit, with the operating costs being met by way of a grant from the Department for Transport (£2.0m), and from the Government of the British Virgin Islands (£0.1m) to cover the costs associated with supporting and assisting the Government in establishing a department of Civil Aviation in the British Virgin Islands.

Following the public expenditure reductions by the UK Government, the company faced significant challenges, as the grant received for the 12 months to 31 March 2012, from the DfT was reduced by £1.0m to £2.0m, a reduction of 33% of the amount received in the previous financial year ending 31 March 2011. The uncertainties surrounding the future funding of the company were resolved during the current financial year and as a consequence as from 1 April 2012 the grant received from the DfT will continue at £2.0m per annum, with the Governments of the OTs providing additional funding to compensate for the reduction in the level of the grant. The DfT has also agreed that the surplus grant from previous years of £1.1m may also be utilised if required to cover any other shortfalls in funding.

Overall Financial Performance

In the year ended 31 March 2012, the CAA recorded a loss before tax of £0.2m (2011 - £1.0m). These results included the effects of IAS 19.

	2011 £m	2010 £m
Group Renenue	**109.4**	110.3
Operating costs (excluding IAS 19 pension scheme adjustments)	**(108.7)**	(108.6)
Group operating profit / (loss)	**0.7**	1.7
IAS 19 pension scheme adjustment	**(15.7)**	(9.7)
Group adjusted operating loss		(15.0)
Net interest	**14.0**	0.6
Loss before taxation	**(1.0)**	(7.4)
Taxation	**(0.6)**	(0.1)
Loss after taxation	**(1.6)**	(7.5)

Within the operating result the regulatory sector, comprising the activities of the Safety Regulation, Regulatory Policy and Consumer Protection Groups as well as the result achieved by CAAi, made an operating profit of £2.3m (2011 - £3.3m) and a profit after adjustments for IAS 19 pension costs and net interest, but before tax, of £1.2m (2011 - £1.5m).

Revenue

Group revenue for the year ended 31 March 2012 was £115.3m (2011 - £109.4m), an increase of £5.9m (5.4%).

The regulatory sector saw an increase of £4.2m (6.1%) to £72.9m (2011 - £68.7m). The increase in income has arisen primarily as a result of average increases of 3% across the main Statutory Charges Schemes for 2011/12 as well as specific price increases on the Economic Regulation of Airports charges that were required to recover the additional cost impact of the Airport Charges Directive.

Income generated within CAAi increased to £15.4m (2011 - £14.5m) in the year, an increase of £0.9m (6.2%), this increase being due to business expansion derived primarily from the EASA contract and new training products.

Operating Costs

Operating costs for the year ended 31 March 2012 were £126.4m (2011 - £124.4m), an increase of £2.0m (1.6%). The significant areas of change are described below:

- Employment costs were £78.6m, a decrease of £0.4m (0.5%) compared to the prior year. The decrease in employment costs is driven by the defined benefit pension costs which decreased by £0.7m to £18.6m during the year, the decrease being attributable to the treatment of defined benefit pension costs in accordance with International Accounting Standard (IAS) 19 'Employee Benefits' for the year ended 31 March 2012. However, the financial results of the Group are assessed by reference to financial targets agreed with the Secretary of State for Transport. This target excludes the effects of IAS 19 on pension costs which are based upon the level of employer cash contributions paid to the CAA Pension Scheme during the financial year. The decrease in pension costs was partially offset by an increase in social security costs following the changes announced in the Finance Act. Payroll costs remained broadly unchanged reflecting the low levels of pay settlement within the Authority.
- Services and materials costs were £15.5m (2011 - £16.5m), a decrease of £1.0m (5.9%). The decrease was principally due to a favourable outcome from the rent review for the CAA's leasehold property in London, and also reduced spend on IT services during the year.
- Repairs and maintenance costs were £2.9m (2011 - £3.1m), a decrease of £0.2m (5.3%) primarily due to reduced IT hardware expenditure during the year.
- External research and development costs were £0.5m (2011 - £0.4m). In addition to third party expenditure, the CAA incurred £0.5m (2011 - £0.4m) of internal costs, bringing the total research and development expenditure to £1.0m, an increase of £0.2m (19.2%) compared to the prior year. The Safety Regulation Group involves the aviation industry in determining the Group's research and development programme, which concentrated on aircraft safety during the year.
- Other expenses were £25.9m (2011 - £22.7m), an increase of £3.2m (13.9%). A significant proportion of this increase relates to additional consultancy costs and other related expenditure in respect of the CAA Development team, the Performance and Process Improvement programme and costs incurred on the pension scheme review. Irrecoverable VAT costs have also increased by £1.1m as a result of a one-off recovery of overpaid VAT in the previous year.

Corporation Tax

The estimated tax charge for this year is £0.1m (2011 - £0.6m). The net deferred tax provision has reduced to £6k as at 31 March 2012 (2011 - £0.4m).

Capital Expenditure

Capital expenditure during the year was kept at a relatively low level of £0.7m, reflecting the stage of the CAA development programme. The capital expenditure primarily included spend on IT development projects and non-discretionary property refurbishment. The net book value of the Group's fixed assets at 31 March 2012 decreased in the year by £2.2m to £16.7m (2011 - £18.9m).

FINANCIAL MANAGEMENT

Treasury Policy

The Board has established terms of reference for treasury policy, covering strategy, control and overall financial management including compliance with any borrowing covenants. All relations with banks and other third parties are governed by dealing mandates, facility letters and other agreements.

The CAA does not enter into speculative treasury arrangements: all transactions in financial instruments are matched to an underlying business requirement. The CAA's Internal Audit function regularly reviews treasury activities. The treasury department works in close liaison with the various business areas within the CAA to manage and minimise all material financial exposures and to anticipate the CAA's funding requirements.

The CAA's policy towards funding is to ensure that it is not constrained by lack of funds needed to meet its operational requirements and is not unreasonably or imprudently bound by restrictive covenants or liquidity risks. Working within the constraints of the public sector, the CAA seeks to ensure that all of its forecast cash needs for a period of at least 12 months ahead are capable of being met within the targets agreed with HM Treasury.

An analysis of the CAA's debt is shown in note 15 to the accounts. The CAA makes its primary placement of surplus Sterling funds with the Debt Management Office (DMO). Surplus funds available for less than one month are placed on short-term or overnight deposit at banks. All deposits are made with banks with money market funding of at least an AA credit rating. The institutions used are kept under constant review to secure the best returns available consistent with the minimum credit rating. The CAA takes steps to limit its credit exposure to individual banks and other counter-parties. Exposure limits are set following a review of credit ratings and aggregate exposures are closely monitored. The majority of the CAA's expenditure is settled in Sterling.

Financing

The CAA borrows sums from the National Loans Fund at fixed rates of interest over specific periods, repaying on an instalment basis. During the year the CAA repaid £1.8m of existing loans. The carrying value of the CAA's outstanding borrowings stood at £9.7m as at 31 March 2012 (2011 - £11.5m). The CAA also has in place a £5.0m overdraft facility with its bankers, Royal Bank of Scotland, which was not utilised during the financial year.

Financial Target

The CAA is set a financial target by the Secretary of State for the regulatory sector, comprising the Safety Regulation, Regulatory Policy and Consumer Protection Groups as well as the result achieved by CAAi. This is to achieve the higher of an annual 6.0% rate of return on average current cost of capital employed or break-even after charging interest and tax. In the year ended 31 March 2012, a rate of return of 4.2% was achieved (2011 – 7.2%).

Land And Buildings

There is a significant difference of £5.0m in the values of land and buildings between the historic cost accounts and the current cost accounts. However, as the CAA does not anticipate any change in use of any of the land and buildings, no market valuations have been disclosed in the historic cost accounts.

BUSINESS SECTOR REVIEW

The CAA's activities are divided into seven sectors, each of which is described below:

Safety Regulation Group

The CAA's Safety Regulation Group (SRG) ensures that UK civil aviation safety standards are set and achieved in a co-operative and cost-effective manner. SRG must satisfy itself that aircraft are properly manufactured, operated and maintained; that airlines are competent; that flight crews, air traffic controllers and aircraft maintenance engineers are fit and competent; that licensed aerodromes are safe to use; and that air traffic services and general aviation activities meet required safety standards.

To monitor the activities of this complex and diverse industry, SRG employs a team of specialists. They have an exceptionally wide range of skills, including pilots qualified to fly in command of current airliners; test pilots able to evaluate all aircraft types; experts in flying training, leisure and recreational aviation activities; aircraft maintenance surveyors; surveyors conversant with the latest design and manufacturing techniques; flight test examiners; aerodrome operations and air traffic control specialists; and physicians skilled in all branches of aviation medicine.

SRG has been significantly restructured in recent years, with some safety regulation responsibilities being transferred to EASA; this transfer of responsibilities has continued over the past financial year. It was agreed with the DfT that some activities associated with the transition of responsibilities to EASA would not be funded by charges to industry or EASA. These transition costs have reduced to £0.8m (2011 - £1.5m) in the year and are not included in the SRG cost base. Instead, they have been transferred to miscellaneous services, where they are funded from existing CAA reserves. SRG also carried out tasks under a commercially arranged contract through CAAi with EASA including type certification, continued airworthiness, design organisation approvals and EASA certification and validation team activities.

The operating costs of SRG for the year ended 31 March 2012 (excluding the effects of IAS 19 pension scheme adjustments) were £59.9m (2011 - £55.5m) an increase of £4.4m (7.9%). Turnover for the year has increased to £59.0m (2011 - £55.8m), a rise of £3.2m (5.7%). The net result was an operating loss of £0.9m (2011 – operating profit of £0.3m). Average staff numbers for the year were 551 (2011 – 546), an increase of 5.

Regulatory Policy Group

The Regulatory Policy Group (RPG) is responsible for the economic regulation of airports and en route air traffic services provided by National Air Traffic Services (NATS). It advises the Government on aviation policy, including the liberalisation of airline markets, issues of economic regulation and competition in the supply of aviation services and infrastructure, and economic aspects of environmental policy. RPG also compiles statistical information on airlines, airports and passengers, which is published by the CAA. In pursuing its regulation, RPG's approach is in general to consider the extent of competition and its implications for regulation and then to involve, to the greatest extent possible, the commercial parties in the regulatory process.

Operating costs of RPG for the year ended 31 March 2012 (excluding the effects of IAS 19 pension scheme adjustments) were £6.8m (2011 - £5.9m), an increase of £0.9m (15.2%). Turnover for the year increased to £7.6m (2011 - £6.1m), an increase of £1.5m (24.6%). The net result was an operating profit of £0.7m (2011 - £0.2m). The average number of RPG headquarters staff in the year ended 31 March 2012 was 60 (2011 – 53). In addition, RPG employed 91 survey staff at airports (2011 – 101), most on a part time basis.

Consumer Protection Group

The Consumer Protection Group (CPG) is responsible for the implementation of European and UK legislation on the licensing of airlines. It also administers the Air Travel Organisers' Licensing (ATOL) scheme: the licensing of air travel organisers selling flights and package holidays in the UK. CPG is responsible for managing the consequences for consumers when an ATOL holder becomes insolvent through organising repatriation flights, dealing with hotels, and paying refunds where appropriate to those who have not yet travelled.

CPG achieved an operating profit of £0.6m (2011 - £0.7m). Operating costs of CPG for the year ended 31 March 2012 (excluding the effects of IAS 19 pension scheme adjustments) were £5.8m (2011 - £6.2m), a decrease of £0.4m (6.5%). The average number of CPG staff in the year ended 31 March 2012 was 63 (2011 - 68).

Directorate Of Airspace Policy

The Directorate of Airspace Policy (DAP) is responsible for policy and planning for the safe, efficient and sustainable use of UK airspace and for supporting air navigation infrastructure. The needs of all users, whether military, commercial air transport or general aviation, are accommodated, as far as possible, having regard for the environment as well as economic and national security considerations.

Operating costs of DAP for the year ended 31 March 2012 (excluding the effects of IAS 19 pension scheme adjustments) were £1.2m (2011 - £1.4m), a decrease of £0.2m (14.3%). Turnover for the year was £1.2m (2011 - £1.5m), a decrease of 20.0%. The primary source of income is from fees for environmental and airspace policy advice to the Government and industry. The net result was breakeven (2011 - breakeven). The average number of DAP staff in the year ended 31 March 2012 was 59 (2011 - 61).

UK En Route Air Traffic Services (UKATS)

The Single European Sky Regulation and the Eurocontrol charging convention require that the costs of providing en route air navigation services be passed on to users of that service and governs UK air traffic charges. The UK en route cost base includes the costs of four entities: NATS (En Route) plc, which constitutes the vast majority of costs; the Met Office; the CAA; and the DfT. The UKATS sector represents the CAA's statutory duties for air traffic service provision. The source of UKATS income is en route charges to aircraft using UK airspace. The published UK unit rate includes a NATS, Met Office, CAA and DfT element.

Income is collected by Eurocontrol and disbursed to each of the four entities. As a regulatory body, the CAA's income is not volume related but is a fixed charge, based on budgeted costs, designed to achieve full cost recovery.

Costs of UKATS for the year ended 31 March 2012 were £8.5m (2011 - £7.0m), an increase of £1.5m (21.4%). UKATS costs comprise costs of the Directorate of Airspace Policy, depreciation charges and costs of capital associated with the refurbishment of the former NATS headquarters building, and legal and financial support to the route charges system.

Turnover for the year was £9.1m (2011 - £7.5m), an increase of £1.6m (21.3%). The net result is an operating profit of £0.6m (2011 - £0.5m).

CAA International

CAAi's principal business activity throughout the year has been to provide independent expert advice to assist clients worldwide to enhance aviation safety. The company provides technical assistance, training and examination services throughout the world. The technical assistance services concentrate on aviation safety and regulation issues, working closely with clients to support their work across the complete spectrum of aviation safety regulation. The company provides international training courses for aviation authorities and industry. It has developed a successful examination service over a number of years, based upon the UK syllabus (CAP 54) with a number of clients. The examination services are specifically designed for civil aviation administration's who need to issue their own professional licences and ratings, but may not have the required resources or expertise to develop their own question bank and testing system. Additionally, the company holds regular seminars to inform industry about the latest regulatory hot topics.

The company had another successful year, achieving a turnover of £15.4m (2011 - £14.5m), the increase being attributable to business expansion derived primarily from the EASA contract and new training products.

The company's operating result (excluding the effects of IAS 19 pension scheme adjustments) was a net operating profit of £1.8m (2011 - £2.1m). The company employed an average of 33 staff during the financial year with a further 42 full time equivalents being supplied from other areas within the Group. A combination of staff supplied from the Authority and management charges in respect of accommodation, IT services, insurance and central administration functions, provided a contribution to the CAA regulatory sector after corporation tax of £8.3m (2011 - £8.2m).

Miscellaneous Services

This includes both the corporate functions of the CAA and other activities, which are either funded or operated by the CAA, but where a degree of independence from the regulatory sector is required. These include:

- CAA Corporate Centre (including CAA Board, HR, IT, Legal, Finance & Corporate Services, and the Development team);
- Air Safety Support International Limited (a subsidiary of the CAA); and
- Other activities (including Aviation Regulation Enforcement, UK Airprox Board, and the administration of the CAA Pension Scheme).

Turnover for the year decreased to £16.7m (2011 - £17.2m), a decrease of £0.5m (2.9%).

The net operating loss for Miscellaneous Services (excluding the effects of IAS 19 pension scheme adjustments) was £2.1m (2011 - £3.1m). The operating loss was partly due to EASA transition costs incurred within the year of £0.8m (2011 - £1.5m). In order to finance these transition activities the DfT and HM Treasury agreed that the associated costs should not be borne by UK industry but financed from existing CAA reserves.

The average number of staff in the year ended 31 March 2012 was 203 (2011 - 207).

FINANCIAL OUTLOOK

Most of the CAA's costs are recovered from those whom it regulates (the regulatory sector) via statutory Charges Schemes. A significant proportion of these charges are based upon activity levels in the aviation industry, such as the number of available seat kilometres that an airline flies during a period. The financial outlook for aviation in 2012/13 remains challenging, therefore the environment within which the CAA operates will also be demanding. We understand the difficulties the industry continues to face and our charging proposals for 2012/13 have been set with this in mind.

The CAA is committed to controlling costs while investing to deliver savings and improvements in the medium to long-term. The CAA has set explicit efficiency targets in its latest Strategic Plan, as it cannot simply let costs increase and expect to recover those increases from industry. As employment costs represent approximately 60% of our total costs, this must be a primary source of efficiencies if we are to deliver an acceptable outcome. Our Performance and Process Improvement programme will deliver a step change in the experience of our stakeholders when they interact with us and enable the efficiencies to be achieved. It is planned that the benefits of this programme will shortly start to deliver a reduced cost of delivering our core processes and in addition streamline current processes while delivering a more flexible resource management model.

Miss C Jesnick
Finance and Corporate Services Director
19 June 2012