

Financial Review

Significant financial developments

The financial year ended 31 March 2013 continued to be a challenging environment for the CAA from a financial perspective, with the suppressed global economic climate continuing to put pressure on income, which is heavily reliant on levels of activity in the aviation sector. The primary income driver in respect of variable charges to industry, is available seat kilometres; these fell by 3.1% in the year to 31 December 2012. Despite these pressures, the CAA achieved a rate of return of 5.5% 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).

Cost saving measures were focused on employment costs which represent approximately 60% of our total costs. During 2012/13, we moved to a performance-based total reward approach for our staff that will enable us to recognise and reward high performance. A benchmarking exercise informed our approach by enabling us to test our relative market position on pay and benefits. In addition, a number of proposals have been adopted to limit our liability to increasing pension costs, these included closing the Defined Benefit Pension Scheme to new entrants and limiting further increases in pensionable earnings to movements in price inflation. The effects of these changes combined with an overall zero based budget

approach to the CAA financial plan has meant that for 2013/14 charges in the majority of cases were held or reduced as compared to 2012/13.

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. 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. Although the CAA is required to comply with International Accounting Standard (IAS) 19 'Employee Benefits' in accounting for pension costs in its financial statements the regulatory 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 CAA section of the Civil Aviation Authority Pension Scheme is currently awaiting the outcome of the formal valuation undertaken at 31 December 2012, the results of which are expected later in the year. 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 on the technical



provisions agreed with the Scheme Actuary, whereas under IAS 19 the accounts show a pension asset of £554.0m (note 18). The methodology underlying the actuarial valuation complies with pensions law and the requirements of the Pensions Regulator, and 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 risk profile and funding 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.

The wholly owned subsidiary company, CAA International Limited, delivered an expanded programme of global advisory services and training, supporting industry and the Government both in the UK and overseas. The company had another successful year, achieving a turnover of £17.1m (2012: £15.4m), an annual increase of 11.0%, despite the difficult trading conditions created by the global economy. The company's operating result saw an increased profit after tax of £2.3m (2012: £1.3m) which principally reflects the increase in income and continued downward drive on operating costs during the year. The company employed an average of 41 staff during the financial year with a further 39 being supplied from other areas within the Group.

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Overall Financial Performance

In the year ended 31 March 2013, the CAA recorded a loss before tax of £3.2m (2012: £0.2m). These results included the effects of IAS 19.

CAA financial performance results		
	2013 £m	2012 £m
Group revenue	125.8	115.3
Operating costs (excluding IAS 19 pension scheme adjustments)	(125.6)	(114.6)
Group operating profit	0.2	0.7
IAS 19 pension scheme adjustment	(5.3)	(11.9)
Group adjusted operating loss	(5.1)	(11.2)
Net interest	1.9	11.0
Loss before taxation	(3.2)	(0.2)
Taxation	0.3	(0.1)
Loss after taxation	(2.9)	(0.3)

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 £2.7m (2012: £2.3m) and a loss after adjustments for IAS 19 pension costs and net interest, but before tax, of £0.2m (2012: £1.2m profit).

Revenue

Group revenue for the year ended 31 March 2013 was £125.8m (2012: £115.3m), an increase of £10.5m (9.1%).

The Regulatory Sector saw an increase of £2.9m (4.0%) to £75.8m (2012: £72.9m). The increase in income has arisen primarily as a result of average increases of 2% across the main Statutory Charges Schemes for 2012/13, as well as income received in the year by the Regulatory Policy Group (RPG) in respect of its periodic review of airport charges.

Income received within the UK En Route Air Traffic Services sector rose by £4.8m compared to the previous year, due to the recovery of additional sums relating to pension liabilities in respect of NATS pensioners inherited at the time of the separation of NATS from the CAA in 2001.

Income generated within CAAi increased to £17.1m (2012: £15.4m) in the year, an increase of £1.7m (11.0%), this increase being due to business expansion derived primarily from the EASA contract as well as new training and examination services.



Operating Costs

Operating costs for the year ended 31 March 2013 were £130.9m (2012: £126.4m), an increase of £4.5m (3.6%). The significant areas of change are described below:

- Employment costs were £78.6m, showing no movement compared to the prior year. Within this figure defined benefit pension costs increased by £0.8m to £21.1m, the increase being attributable to the treatment of defined benefit pension costs in accordance with International Accounting Standard (IAS) 19 'Employee Benefits'. 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 and reflects instead the level of employer cash contributions paid to the CAA Pension Scheme during the financial year. The increase in pension costs was offset by a decrease in salary costs resulting from the reduction in staff numbers and a pay freeze within the Authority. The average number of employees disclosed in note 3 to the accounts does not reflect the true trend in staff numbers as a significant number left the organisation in the last two months of the year. The number of full time equivalents as at 31 March 2013 showed a reduction of 25 compared to the same time last year;
- Services and materials costs were £15.4m (2012: £15.5m), a decrease of £0.1m (0.6%). The decrease was principally due to a reduced level of IT software expenditure in the year;
- Repairs and maintenance costs were £2.7m (2012: £2.9m), a decrease of £0.2m (6.9%) primarily due to reduced IT hardware and IT support expenditure during the year;
- External research and development costs were £0.6m (2012: £0.5m). In addition to third party expenditure, the CAA incurred £0.6m (2012: £0.5m) of internal costs, bringing the total research and development expenditure to £1.2m, an increase of £0.2m (20.0%) 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 £31.2m (2012: £25.9m), an increase of £5.3m (20.5%). A significant proportion of this increase relates to additional costs developing a CAA-wide enterprise architecture and business analysis to carry out business process re-engineering on the major areas of the business. Additional costs were also incurred on the pension scheme review and RPG professional fees increased by almost £1.0m as a result of activities carried out in connection with the Airport Charges Review.

Corporation Tax

The estimated tax credit for this year is £0.3m (2012: £0.1m expense). A net deferred tax asset of £75k is now recognised in the balance sheet, a movement of £81k compared to the net deferred tax liability of £6k provided last year.

Capital Expenditure

Capital expenditure during the year totalled £1.7m. The 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 2013 decreased in the year by £1.1m to £15.6m (2012: £16.7m).

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.

“The CAA is committed to ensuring equality of opportunity.”

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 £1.9m of existing loans. The carrying value of the CAA's outstanding borrowings stood at £7.8m as at 31 March 2013 (2012: £9.7m). 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 2013, a rate of return of 5.5% was achieved (2012: 4.2%).

Land and Buildings

There is a significant difference of £4.1m 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.

CAA Equality and Diversity Policy

The CAA is committed to ensuring equality of opportunity. It is our policy to treat all employees and job applicants fairly and equally regardless of their sex, sexual orientation, marital status, age, disability, race, colour, nationality, ethnic or national origin, religion or belief.

In respect of recruitment, career progression and development, the CAA will ensure that no requirement or condition will be imposed without justification that could disadvantage an individual on any of the above grounds. Wherever possible, efforts will be made to identify and remove unnecessary or unjustifiable barriers and provide appropriate facilities and employment conditions to meet the needs of any under-represented groups.

We are committed to the implementation of this policy and to a programme of action to ensure that the policy is, and continues to be, fully effective. We will regularly review supporting policies, procedures and selection criteria to ensure that individuals are selected, promoted and otherwise treated according to their relevant individual abilities and merits. All employees are required to attend equality and diversity awareness training.

To ensure this policy is operating effectively, and for no other purpose, the CAA maintains records of employees' and applicants' racial origins, gender, disability and age group. Ongoing monitoring and analysis of this information will form the basis for

“...the Safety Regulation Group employs a team of specialists. They have an exceptionally wide range of skills...”

appropriate action to eliminate discrimination and promote equality of opportunity.

The CAA values the different ways employees contribute to organisational goals and performance. We aim to provide everyone with the opportunity to contribute and compete on equal terms and we promote fairness by ensuring that decisions made about people are based on merit.

The CAA recognises the positive contribution that individual differences can bring and how these factors will support the CAA's stated Mission, Value and Guiding Principles in particular:

- Maintaining and developing excellence in people;
- Working together effectively, internally and externally;
- Developing and empowering staff, and valuing their contribution;

- Continuously improving performance and processes.

The CAA's commitment to taking action to embed equality and diversity into the organisation is relevant to all that we do and we will:

- Understand, value and welcome equality and diversity in our workforce;
- Ensure that all relevant policies reflect our commitment to action;
- Promote positive behaviours by treating people with respect, consideration and without prejudice;
- Support the use of flexible working patterns wherever possible to enable employees to balance work and home responsibilities.



“Regulatory Policy Group’s approach is in general to consider the extent of competition and its implications”

Business Sector Review

The CAA’s activities are divided into seven sectors, each of which are 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 £0.7m (2012: £0.8m) 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 2013 (excluding the effects of IAS 19 pension scheme adjustments) were £60.3m (2012: £59.9m) an increase of £0.4m (0.7%). Turnover for the year has increased to £59.9m (2012: £59.0m), a rise of £0.9m (1.5%). The net result was an operating loss of £0.4m (2012: loss of £0.9m). Average staff numbers for the year were 555 (2012: 551), an increase of 4.

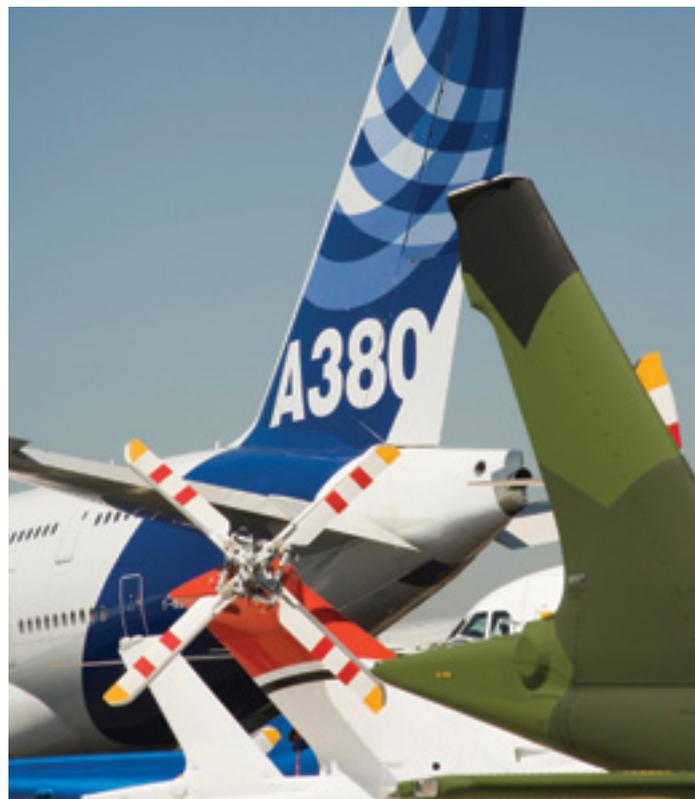
Regulatory Policy Group

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 2013 (excluding the effects of IAS 19 pension

scheme adjustments) were £8.9m (2012: £6.8m), an increase of £2.1m (30.9%). RPG professional fees increased by almost £1.0m as a result of activities carried out in connection with the Airport Charges Review. Turnover for the year increased to £9.1m (2012: £7.6m), an increase of £1.5m (19.7%). The net result was an operating profit of £0.2m (2012: £0.7m). The average number of RPG headquarters staff in the year ended 31 March 2013 was 61 (2012: 60). In addition, RPG employed 102 survey staff at airports (2012: 91), 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 result of break-even (2012: £0.6m profit). Operating costs of CPG for the year ended 31 March 2013 (excluding the effects of IAS 19 pension scheme adjustments) were £6.8m (2012: £5.8m), an increase of £1.0m (17.2%). The average number of CPG staff in the year ended 31 March 2013 was 60 (2012: 63).

“CAAi’s principal business activity throughout the year has been to provide independent expert advice to assist clients worldwide to enhance aviation safety.”

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 2013 (excluding the effects of IAS 19 pension scheme adjustments) were £1.0m (2012: £1.2m), a decrease of £0.2m (16.7%). Turnover for the year was £1.2m (2012: £1.2m), no change from the previous year. The primary source of income is from fees for environmental and airspace policy advice to the Government and industry. The operating profit for the year was £0.2m (2012: break-even). The average number of DAP staff in the year ended 31 March 2013 was 59 (2012: 59).

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; it also governs UK air traffic charges. The UK en route charges to aircraft using UK airspace recover the costs of four entities: NATS (En Route) plc, which incurs the

vast majority of costs recovered through en route charges; the Met Office; the CAA; and the DfT.

Income is collected by Eurocontrol and disbursed to each of the four entities. As a regulatory body, the CAAs 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 2013 were £12.6m (2012: £8.5m), an increase of £4.1m (48.2%). The CAA’s UKATS costs arise from 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. Operating costs rose by £4.8m compared to the previous year, due to the recovery of additional sums relating to pension liabilities in respect of NATS pensioners inherited at the time of the separation of NATS from the CAA in 2001.

Turnover for the year was £13.9m (2012: £9.1m), an increase of £4.8m (52.7%). The net result is an operating profit of £1.2m (2012: £0.6m).

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 advisory services, training and examination services throughout the world. The advisory services concentrate on aviation

“most of the CAA’s costs are recovered from those that it regulates...”

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), and has a number of clients. The examination services are specifically designed for civil aviation administrations 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 £17.1m (2012: £15.4m), the increase being attributable to business expansion derived primarily from the EASA contract and new training and examination services.

The company’s operating result (excluding the effects of IAS 19 pension scheme adjustments) was a net operating profit of £2.9m (2012: £1.8m). The company employed an average of 41 staff during the financial year with a further 39 full time equivalents being supplied from other areas within the CAA. 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 £7.7m (2012: £8.3m).

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

Turnover for the year increased to £17.9m (2012: £16.7m), a rise of £1.2m (7.2%).

The net operating loss for Miscellaneous Services (excluding the effects of IAS 19 pension scheme adjustments) was £3.9m (2012: £2.1m). The operating loss was partly due to EASA transition costs incurred within the year of £0.7m (2012: £0.8m) and the cost incurred as part of the CAA Performance and Process Improvement programme. 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 2013 was 199 (2012: 203).



Financial Outlook

As most of the CAA's costs are recovered from those that it regulates via Statutory Charges Schemes, the aviation industry and consumers expect the CAA to use the statutory income it receives efficiently and effectively. Our challenge is to ensure that the CAA is highly efficient without jeopardising the role it undertakes as the UK aviation regulator. 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. During 2012/13, we moved to a performance-based total reward approach for our staff that will enable us to recognise and reward high performance. A benchmarking exercise informed our approach by enabling us to test our relative market position on pay and benefits. In addition, a number of proposals have been adopted to limit our liability to increasing pension costs, these included closing the Defined Benefit Pension Scheme to new entrants and limiting further increases in pensionable earnings to movements in price inflation. The effects of these changes combined with an overall zero based budget approach to the CAA financial plan has meant that for 2013/14 charges in the majority of cases were held or reduced as compared to 2012/13.

During 2013/14 and beyond, 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 target efficiencies to be achieved. It is planned that the benefits of this programme will shortly start to realise a reduced cost of delivering our core processes and, in addition, streamline current processes whilst delivering a more flexible resource management model.

Miss C Jesnick

Finance and Corporate Services Director
18 June 2013