



**Promoting Financial Resilience for Major Airports  
Response of the Civil Aviation Authority**

**February 2010**

**Civil Aviation Authority**

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## Summary

1. The CAA welcomes the opportunity to respond to the DfT's consultation on proposals to introduce a Continuity of Service Plan (CSP) and a requirement for the CAA to meet additional conditions before certain financial licence conditions can be 'switched on'.

### Continuity of Service Plan

2. The CAA supports the DfT's proposals for a CSP and considers that licence conditions should be included in the initial Tier 1 licences for the airport operators to prepare and maintain a CSP. The CAA would be happy to provide advice on the precise drafting of these licence conditions in due course.
3. One particular issue that will need to be resolved when drafting the detailed licence conditions is the level of scrutiny of the CSP that is undertaken by the CAA. In order to mitigate the costs associated with implementing and monitoring the CSP obligations, the CAA considers that this scrutiny should be along the lines that the CAA would "assess whether the CSP is reasonably expected to provide a prospective insolvency practitioner with reasonably comprehensive information relevant to maintaining service continuity."

### Proposal for additional tests when 'switching on' ring-fencing conditions

4. The CAA recommends that the DfT pursue one of two approaches to the introduction of licence conditions to bring in a full financial ring-fence. First, the DfT could place reliance on the combination of the proposed statutory duties and the proposed appeals regime, rather than implement a separate mechanism to deal with the financial licence conditions (i.e. Option 1). The proposed statutory duties are clearly framed to protect the interests of current and future consumers and therefore would require the CAA to consider the impact of its decisions on the finances of airport operators on consumers' interests, including any adverse impacts on investment. Further, to the extent that the CAA fails to demonstrate that a change is in consumers' interests, the airport would be able to trigger an appeal to the CC (for a full, investigative appeal). This approach would be simple and would not involve any additional implementation costs. It is the CAA's favoured approach.
5. Alternatively, if the DfT were to implement a specific mechanism for the financial licence conditions, the CAA recommends that:
  - the CAA be given a power to lift the derogations issued by the Secretary of State against the initial financial licence conditions;
  - any CAA proposal to lift a derogation be subject to an adjudicative appeal (triggered by the licensee, Passenger Focus or the Secretary of

State), which the CC would then consider against the CAA's statutory duties (rather than against the proposed supplementary tests); and

- if the CAA considers that an alternative licence condition should be introduced that any such proposal be treated as if it were a new licence condition and subject to the standard licence modification process (with its investigative appeals processes.)

These adjustments would improve the clarity of the DfT's proposals, by removing the need for 'supplementary tests' and simplifying the overall process, by avoiding the need for a two-stage appeals process whenever financial licence conditions should be modified prior to being 'switched on'.

### **Structure of this response**

6. The remainder of this response is structured in two chapters. The first considers the proposal for a CSP. The second considers the proposed mechanism for 'switching on' financial licence conditions. In each case, the CAA has set out estimates of the costs that it might incur as a result of the proposals. Responses to the individual consultation questions are at the end of each of the two chapters.

# 1. Proposal for a Continuity of Service Plan

## Introduction

- 1.1 This chapter considers the proposal for the initial Tier 1 airports to prepare and maintain a Continuity of Service Plan (CSP).
- 1.2 This chapter is structured in three main sections. The first outlines the key features of the proposal. The second discusses the costs and benefits of the proposal. The final section provides a summary recommendation and answers to the consultation questions.

## The proposal

- 1.3 The key features of the proposal are that:
- a licence condition would be included within the initial Tier 1 licences to implement the CSP proposal;
  - these licence conditions would oblige the licensee to prepare and maintain a CSP;
  - the obligation to prepare and maintain a CSP could be extended to an airport entering Tier 1, under the proposed licence modification process; and
  - once implemented, the CSP licence conditions would be subject to the proposed licence modification process.
- 1.4 It follows that the proposal would not place an obligation on the airport to maintain continuity of service. Rather, the proposal is intended to improve the information available to any prospective administrator, thereby reducing the likelihood that service continuity is not maintained during a period of administration<sup>1</sup>. As noted below, the CSP would also provide the CAA with a tool to identify ways to increase the likelihood that service continuity is maintained.

### *Practical implementation*

- 1.5 The consultation document recognises that, in order to implement the above proposal, it would be necessary to include within the initial Tier 1 licences a number of CSP obligations, including obligations on the licensee to:
- prepare a CSP;
  - obtain the CAA's approval that the CSP is suitable; and

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<sup>1</sup> Throughout this response, the CAA refers to an 'administrator' and 'administration'. In practice, it is possible for the airport to be put into receivership and for a receiver to be appointed. This distinction does not affect the arguments made in this paper.

- maintain the CSP and update it following any material change in circumstances.
- 1.6 The CAA would then need to undertake some form of scrutiny of the draft CSP, in order that the CAA can give its consent to the document. This is likely to involve securing external, expert advice from insolvency practitioners. The CAA would expect to review the contents of the CSP in order to identify whether there is a need for any further action. For example, if the CSP identified a contract that would fall upon the appointment of an administrator and that this contract might undermine continuity of service, there might be a need for the CAA to consider whether this was appropriate and/or whether any further regulatory intervention was warranted.
- 1.7 Finally, the CAA would also need to undertake some form of ongoing monitoring and/or annual approvals process in order to ensure that the CSP remains fit for purpose.

## **Assessment**

### *Costs*

- 1.8 Airport licensees would incur the majority of the costs of the proposals, when preparing and updating the CSP. The extent to which these costs are ultimately borne by airlines and consumers will depend upon the nature of airport and airline competition and the form of regulation applied to the airports.
- 1.9 The CAA would also incur significant costs in administering the CSP licence obligations. There would also be additional costs associated with implementing the proposal – principally the cost of drafting the relevant licence conditions. Interested parties might be expected to incur some costs in order to participate in the licence drafting process.
- 1.10 We have sought to provide indicative figures for the cost associated with the CAA's activities, on the assumption that airport operators and other interested parties are best placed to provide an estimate of the costs that they might face.
- 1.11 The CAA's estimates of the costs that it would incur are set out in Table 1 below, together with a short explanation of the rationale for the cost estimates. However, the CAA's costs will vary depending upon the level of scrutiny applied to the 'approval' of the CSP. The analysis below assumes that the CAA's assessment has an objective along the lines of "whether the CSP is reasonably expected to provide a prospective insolvency practitioner with reasonably comprehensive information relevant to maintaining service continuity."

**Table 1 Cost estimates of implementing and maintaining a CSP (CAA costs only)**

<b>Cost item</b>	<b>Estimate<sup>2</sup></b>	<b>Notes</b>
Drafting initial licence conditions (one-off cost, covering all initial Tier 1 licences)	<i>Internal costs:</i> 20-40 working days ≈ £10k - £20k	- To cover drafting and governance processes <sup>3</sup> - The existing licence drafting project reduces the cost estimate.
Approving the initial CSP (one-off cost, per licensed airport)	<i>Internal costs:</i> 40-80 working days ≈ £20k - £40k  <i>Consultancy cost:</i> £50k – £100k	- To cover contracting with consultancy, review of their work and internal governance processes - Consultancy cost based on an estimate of 20 working days by senior consultants plus some partner-level review
Reviewing the CSP (Annual cost from year 2, per licensed airport)	<i>Internal costs:</i> 20-40 working days ≈ £10k - £20k  <i>Consultancy cost:</i> £25k – £50k	- To cover contracting with consultancy, review of their work and internal governance processes - Assumes that no major issues are raised by the review - Consultancy cost based on an estimate of 10 working days by senior consultants plus some partner-level review

Source: CAA cost estimates

- 1.12 In preparing the above indicative estimates, the CAA has not obtained advice from insolvency practitioners, who would be better placed to judge the likely cost of securing their services.
- 1.13 It is also possible that the proposal might result in additional costs (that exceed the relevant benefits) if it were applied to a smaller airport, should one be moved into Tier 1. The ability of the CAA to tailor licence conditions to the individual circumstances of each Tier 1 airport would, however, allow the CAA to ensure that such a licence obligation was not placed on an airport where there would be no incremental benefit to doing so. Consequently, given the proposed flexible licensing regime, the proposal should not have an adverse impact upon such airports in future.

### *Benefits*

- 1.14 The CAA agrees with the DfT that the nature of the major UK airports is such that it is highly likely that any administrator would seek to maintain continuity of service, as doing so incurs few incremental operating costs but would generate substantial incremental revenues.
- 1.15 The principal benefit of a CSP is that it would bring together information about the day-to-day operations of the airport and its ownership and financial

<sup>2</sup> The estimates of internal CAA costs are based on a crude estimate of costs per day. The actual costs incurred will depend both on the duration of the projects and the amount of senior review and clearance that is needed. The numbers quoted in this table should, therefore, be viewed as indicative only.

<sup>3</sup> Governance processes would include senior review, policy committee meetings and, where appropriate, board meetings to approve publications and decisions.

structures, so providing practical assistance to the administrator in maintaining continuity of service. The CAA agrees with the material set out in pages 4 and 5 of the consultation document that seeks to quantify the costs of service interruption, though – as the DfT recognises – it is difficult to convert these estimates into an expected costs, due to the very low, yet uncertain, probability of these costs being incurred.

- 1.16 The CAA considers that the implementation of the CSP might be expected to generate benefits in addition to those identified in the draft impact assessment. First, it might increase the credibility that airports would be allowed to enter administration, sharpening the incentives of airport owners' (and providers of finance) to adopt appropriate financial structures. Second, the costs incurred during a period of administration might be lower, reflecting the fact that the airport operator would have already brought together much of the information needed by the administrator. Third, the preparation of the CSP might identify arrangements that might unduly increase the likelihood of service discontinuity. This could help the CAA to take further regulatory action (be it through additional licence conditions, or other means) that would themselves generate net benefits. Due to their contingent nature, it is difficult to quantify these benefits in monetary terms.
- 1.17 However, it should be emphasised that whilst the CSP might reduce the likelihood of discontinuity of service, it cannot be expected to *guarantee* that some form of disruption will not occur. Similarly, whilst the CAA expects that any administrator would find the CSP useful, there can be no guarantee that an administrator would use the CSP.

## **CAA position**

### *Overall*

- 1.18 The CAA agrees with the DfT's proposal to include licence conditions in the initial Tier 1 licences for the airport operators to prepare and maintain a CSP.
- 1.19 The CAA considers that the costs involved in implementing and monitoring the CSP would be mitigated by ensuring that the level of scrutiny undertaken by the CAA is along the lines that it would "assess whether the CSP is reasonably expected to provide a prospective insolvency practitioner with reasonably comprehensive information relevant to maintaining service continuity."

### *Response to consultation questions*

- 1.20 This section provides responses to the specific questions set out in the consultation document.
- Q.1 Should the regulatory regime include a licence condition to produce and maintain a CSP in the initial licence and allow the regulator to introduce such a licence condition in future licences?**

1.21 As discussed above, the obligation should be included in the initial Tier 1 licences and the inclusion of the CSP obligations in any future Tier 1 licences for airports moved into Tier 1 should be governed by the normal licence modification process. This would allow the CSP obligations to be added to these licences but would avoid the risk that the CSP obligations are applied where the benefits of doing so do not outweigh the costs.

**Q.2 If such a licence condition were to be introduced, what would be the costs and benefits of such a step?**

1.22 The CAA has set these out above.

**Q.3 If such a licence condition were to be introduced, is there any information in the list above that is not required, and why is it not required? Is there any additional information that should be included in a Continuity of Service Plan, and if so why?**

1.23 The CAA recommends against the licence condition setting out a prescriptive list of the items that should, or should not, be included in the CSP. Instead, the licence obligations should place a general obligation on the airport to prepare a CSP that is fit for purpose and for the licensee to secure the CAA's approval. This would provide a more flexible approach to the preparation of the CSP and allow it to be tailored to the individual circumstances of each airport.

**Q.4 If such a licence condition were to be introduced, how often or on what basis would the plan need to be updated in order for it to remain relevant?**

1.24 The CAA recommends that the periodicity of such reviews might not need to be specified in the licence. Rather, the licensee could be obliged to update the CSP when there is a material change in circumstances. This obligation could be reinforced by the ability of the CAA to oblige the licensee to undertake a review of the CSP. Such an approach would provide sufficient flexibility to ensure that the plan remains fit for purpose, whilst avoiding the need to specify a specific period, which could turn out to be inappropriate.

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## 2. Proposal for additional tests when ‘switching on’ ring-fencing conditions

### Introduction

- 2.1 This chapter considers the proposal to introduce an additional process for the introduction of licence conditions relating to the implementation of a financial ring-fence on Tier 1 airports (the “switching on” mechanism).
- 2.2 This chapter is structured in three main sections. The first outlines the key features of the proposal. The second discusses the costs and benefits of the proposal. The final section provides a summary recommendation and answers to the consultation questions.

### The proposal

- 2.3 The DfT’s proposed “switching on” mechanism would operate in the context of the Tier 1 airports holding a licence that contained a number of licence conditions relating to their financial structure. The DfT has announced its intention that these initial licences would contain a number of obligations to give effect to a financial ring-fence, to the extent that such a ring-fence does not ‘cut across’ the existing finances of the Tier 1 airport operators.
- 2.4 The proposed “switching on” mechanism would introduce additional conditions that would need to be met before any financial ring-fence was extended. In this way, the proposal has the objective of providing additional protections – beyond those provided the statutory duties and appeals mechanisms – to the owners of the Tier 1 airports, by constraining the regulator’s ability to make changes to the Tier 1 licences.<sup>4</sup>
- 2.5 In general terms, there appear to be two ways in which the proposed ‘switching on’ mechanism might work.
- 2.6 Under the first, the full financial ring-fence is introduced into the initial licences but, before these licences take effect, the Secretary of State would issue a ‘derogation’<sup>5</sup> to permit the licensee not to comply with the set of conditions that are judged to ‘cut across’ the licensee’s finances. Under this approach, the CAA could be given a power to lift the derogations issued by the Secretary of State and thus ‘switch on’ the licence obligations set out in the initial licence. The CAA refers to this approach as the ‘derogations approach’.

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<sup>4</sup> The Impact Assessment (page 2) recognises that the proposal may make it harder for the regulator to switch on provisions and to move to a full ring-fence.

<sup>5</sup> “Derogations” are used to relieve a licensee from complying with certain obligations contained in a licence. The CAA does not have any general powers to issue derogations from licence conditions under the Transport Act 2000. However, there is a power held by the Secretary of State to exempt suppliers of a particular description from the need to hold a licence. The CAA understands that the DfT is not proposing to include in legislation any powers for the CAA either to exempt airports from the need to hold a licence or to derogate in respect of conditions included in airport licences.

- 2.7 Under the second, whilst the full financial ring-fence might be contained in the initial licences, any licence conditions that ‘cut across’ the licensee’s finances would be drafted in such a way as to require modification before they take effect. Under this approach, the CAA could use its proposed powers to modify licence conditions in order to ‘switch on’ the licence obligations. The CAA refers to this approach as the ‘licence modification approach’.
- 2.8 The consultation document refers to the Secretary of State issuing derogations for elements of the financial ring-fence that cut across the licensee’s existing financial structure. It also states that the removal of the initial derogations would be “by way of licence modification”.<sup>6</sup> Consequently, the CAA considers the main costs and benefits associated with both the ‘derogations’ and ‘licence modification’ approaches.
- 2.9 Under either approach, the proposed “switching on” mechanism would apply to any variation of conditions associated with a financial ring-fence and is designed to set supplementary conditions that would need to be met before the CAA is able to initiate a licence modification proposal to add to the financial ring-fence obligations set out in the initial Tier 1 licences.

*The derogations approach to ‘switching on’ conditions*

- 2.10 The derogations approach would result in the following process to bring into effect additional financial ring-fencing obligations:
- The CAA would first identify that there is a case for extending the financial ring-fencing obligations contained in one or more of the Tier 1 licences, and undertake appropriate consultation with interested parties to inform its analysis.<sup>7</sup>
  - The CAA would then reach a decision as to whether the “supplementary tests” are met, namely that:
    - a. there has been “a material change in circumstances” when compared to the point at which the initial Tier 1 licences were given legal effect; and
    - b. “the benefits of the proposed modification exceed the costs”.

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<sup>6</sup> Paragraph 27 refers to the objective of the proposal being “to develop some additional certainty as to the circumstances in which the regulator is able to remove or seek to remove existing derogations to ring-fencing conditions by way of licence modification...”. In addition, paragraph 43 of the consultation document states that future ‘derogations’ would be “dealt with under the licence modification process”. Paragraph 44 states that if a regulated company wished to obtain a ‘derogation’ that this “would be a licence modification matter”.

<sup>7</sup> Such consultation would be consistent with good regulatory practice, the Better Regulation principles and the proposed statutory duties for the CAA. Paragraph 38 of the consultation document states the DfT’s intention that there would be consultation prior to any decision on whether the ‘supplementary tests’ were met.

- If these two tests were met, the CAA would then be able to propose to lift (one or more of) the derogations issued by the Secretary of State.
- This proposal to lift the derogations would be subject to appeal, which could be triggered by the airport licensee, Passenger Focus or the Secretary of State. This appeal would be heard by the CC on an “adjudicative” basis (i.e. focused on “errors of fact or law of a wrong exercise of discretion”).
- If no appeal is lodged, or the CAA decision is endorsed by the CC, the derogation would be lifted and the relevant licence conditions (as originally drafted in the initial licences) would have legal force.

2.11 If the CAA considered that there was a case to amend the licence condition before it took effect then the CAA would – rather than lifting the derogation – instigate the normal licence modification process. This process would involve a separate consultation on the appropriate modification to the licence conditions and provide for a separate appeals process.<sup>8</sup> This appeals process could be triggered by the airport licensee, Passenger Focus or the Secretary of State. This appeal would be heard by the CC on an “investigative” basis, allowing the CC to consider new evidence and new arguments during the appeal stage. The CC’s conclusions on the appeal would be binding on all parties.

*The licence modification approach to ‘switching on’ conditions*

2.12 The licence modification approach would result in the following process to bring into effect additional financial ring-fencing obligations:

- The CAA would first identify that there is a case for extending the financial ring-fencing obligations contained in one or more of the Tier 1 licences, and undertake appropriate consultation with interested parties to inform its analysis.<sup>9</sup>
- The CAA would then reach a decision as to whether the “supplementary tests” are met, namely that:
  - a. there has been “a material change in circumstances” when compared to the point at which the initial Tier 1 licences were given legal effect; and
  - b. “the benefits of the proposed modification exceed the costs”.

<sup>8</sup> Paragraph 42 states the DfT’s intention that the licence modification process to ‘switch on’ additional financing licence conditions would be subject to the appeals process set out in the DfT’s decision on the overall licence modification process. This process involves an “investigative” appeal process, heard by the CC and triggered by the licensee, Passenger Focus or the Secretary of State.

<sup>9</sup> Such consultation would be consistent with good regulatory practice, the Better Regulation principles and the proposed statutory duties for the CAA. Paragraph 38 of the consultation document states the DfT’s intention that there would be consultation prior to any decision on whether the ‘supplementary tests’ were met.

- The decision as to whether (a) and (b) are met would be subject to appeal, which could be triggered by the airport licensee, Passenger Focus or the Secretary of State. This appeal would be heard by the CC on an “adjudicative” basis (i.e. focused on “errors of fact or law or a wrong exercise of discretion”).
- If no appeal is lodged, or the CAA decision is endorsed by the CC, the CAA would then be permitted to instigate the “standard licence modification process”<sup>10</sup>.
- Under the standard licence modification process the CAA would need to establish that the modifications to introduce (i.e. ‘switch on’) additional ring-fencing licence obligations would further its statutory duties.
- The principles of Better Regulation and the proposed statutory duties for the CAA would strongly suggest that there would be a process of consultation with stakeholders (including airlines) on whether the proposal met the statutory duties, i.e. met a different legal test the proposed “supplementary tests”.
- Should the CAA decide to instigate the standard licence modification process, this decision would also be subject to appeal<sup>11</sup>.
- This final appeal stage could be triggered by the airport licensee, Passenger Focus or the Secretary of State. This appeal would be heard by the CC on an “investigative” basis, allowing the CC to consider new evidence and new arguments during the appeal stage.
- The CC’s conclusions on the appeal would be binding on all parties.

### *Practical implementation under either approach*

2.13 In addition to the above processes, the normal rights of Judicial Review would be available to all affected parties at any stage in the process. In particular, this would allow affected airlines or other airport operators to instigate an appeals process through the courts.

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<sup>10</sup> Paragraph 27 of the consultation document states that the proposal sets “conditions that the regulator must demonstrate have been satisfied, after which the regulator can initiate the standard licence modification process”.

<sup>11</sup> Paragraph 42 states the DfT’s intention that the licence modification process to ‘switch on’ additional financing licence conditions would be subject to the appeals process set out in the DfT’s decision on the overall licence modification process. This process involves an “investigative” appeal process, heard by the CC and triggered by the licensee, Passenger Focus or the Secretary of State.

## Assessment

### Costs

2.14 The CAA considers that the costs associated with the proposal can be broken down into a number of areas:

- a lack of clarity as to the legal test that applies to licence modifications / lifting of derogations;
- the effects of the limitations placed on the CAA's ability to implement changes that meet its statutory objectives; and
- a number of specific implementation costs, including:
  - establishing appropriate processes and procedures to implement the 'supplementary tests';
  - the additional costs associated with establishing whether the 'supplementary tests' have been met;
  - the additional costs associated with appeals as to whether the 'supplementary tests' have been met; and
  - the potential for the mechanism to result in perverse outcomes.

These are considered below.

### Lack of clarity

2.15 The DfT's proposal introduces two supplementary tests that must be met before the CAA can instigate changes that are intended to meet its statutory objectives. However, the consultation document does not explain why these 'supplementary tests' differ from the CAA's proposed statutory duties. These proposed duties – when combined with the proposed appeals regime – have been designed to ensure that the CAA's decisions are appropriate.

2.16 If we first consider the rationale for the first supplementary test, this test would only permit the CAA to 'switch on' a financial licence modification if there is a 'material change in circumstances'. However, assuming that the initial licence is designed in a way that (based on the information available at the time) best meets the CAA's statutory duties, subsequent licence modifications would only be initiated if circumstances change in some way. In other words, the first 'supplementary test' appears to replicate a discipline that would in any case exist.

2.17 Alternatively, the proposal for 'supplementary tests' might be motivated by the possibility that the initial licences would be designed in a way that would be incompatible with the CAA's statutory duties. The first supplementary test would, therefore, be designed to constrain the CAA's ability to bring the initial

licences into line with its statutory duties. The CAA does not consider that this is the DfT's intention and has not identified a reason why the initial licences would be designed in such a way. Indeed, the CAA's understanding is that the Secretary of State, when issuing the initial licences, would be operating under the same statutory duties as proposed for the CAA.

- 2.18 Turning to the second supplementary test. This test would only permit the CAA to 'switch on' a financial licence modification if the "benefits ... exceed the costs". Again, it is unclear why the CAA's proposed statutory duties and appeal regime would not deliver this outcome. Indeed, the proposed statutory duties include a secondary duty to:

"have regard to the principles of Better Regulation and any other principles appearing to represent the best regulatory practice, and to consult with stakeholders, including airlines."

- 2.19 In light of the explicit references to Better Regulation and 'best regulatory practice' in the proposed statutory duties, it seems highly unlikely that the CAA could propose a licence modification that was not likely to deliver benefits that exceed the costs, without being successfully appealed.

- 2.20 It is possible that the assessment under the second of the 'supplementary tests' could be undertaken under a different basis – perhaps placing different weights on the various costs and benefits – from that which should apply when considering issues against the statutory duties. However, the CAA can identify no reason why the second 'supplementary test' would involve a cost-benefit appraisal that would differ from that undertaken against the CAA's statutory duties.

- 2.21 However, under the derogations approach, the supplementary tests would offer some protection to interested parties, whilst providing the CAA with the ability to lift derogations without recourse to the full licence modification process. The CAA recommends that, under this approach, it would be clearer if the test for triggering an appeal of the decision to lift a derogation were whether the lifting of the condition was consistent with the CAA's statutory duties.

- 2.22 Under the licence modification approach, the CAA recommends that the use of the supplementary tests, together with the additional (adjudicative) appeals process, is not warranted. Instead, the DfT should place reliance on the standard licence modification process to bring into effect a full ring-fence.

- 2.23 These modifications would improve the clarity of the proposed mechanism and avoid introducing unnecessary regulatory risk. These modifications to the proposal would also ensure that the CAA was able to maintain its

approach to regulating financial structures – an approach that has recently been endorsed in the DfT’s decision document.<sup>12</sup>

## Placing limitations on the CAA’s ability to discharge its statutory objectives

- 2.24 Under the ‘licence modification approach’, the overall effect of the proposal would be significantly to constrain the CAA’s ability to extend the licence conditions relating to financial ring-fences. In particular, the CAA’s decision-making process would be subject to two sets of appeals, the first against the supplementary tests, the second against the statutory duties. It is conceivable that, as the relevant statutory test and evidential hurdles differ in the two appeals, the CAA could be successful at the first appeal but lose the second. However, whilst the additional (adjudicative) appeal does not provide parties with any greater ability to trigger meaningful external scrutiny than the standard appeal, it could provide them with the ability to slow down the process by which licence modifications are brought into effect.<sup>13</sup>
- 2.25 In light of this, the practical consequence of the additional appeals mechanism appears to be to provide some parties with the ability to slow down the process by which financial licence modifications are implemented. Where these modifications are justified by the statutory duties, such a delay would result in costs to consumers.<sup>14</sup> This delay could be significant. Whilst the CC adjudicative appeal process might take as little as 3 months to complete, judicial review proceedings – which could also be triggered at this initial stage – typically take much longer.<sup>15</sup>
- 2.26 The costs of such a delay to appropriate licence modifications are difficult to quantify but could be significant, particularly if the proposed modifications were intended to extend protections to consumers against the consequences of inappropriate financial structures. It is also questionable whether the complexity of the process and the resulting time taken to instigate changes are consistent with Better Regulation principles.
- 2.27 It could be argued that the supplementary tests are needed to protect the airport operators’ finances, and have some meaning that is genuinely additional to the policy intent captured by the statutory duties. However, it is unclear what additional protection (other than the power to instigate delay) is afforded to the airport licensee, as the proposed statutory duties refer explicitly to the need to protect current and future consumer interests. The consequences of any licence modification on future investment would,

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<sup>12</sup> The DfT’s support for the CAA’s approach to regulating finance was confirmed, as set out in the CAA’s statement of the 13 October 2009 (available at: <http://www.caa.co.uk/application.aspx?catid=14&pagetype=65&appid=7&newstype=n&mode=detail&nid=1797>).

<sup>13</sup> Due to the different bases for the appeals processes, it would be possible for the CAA to successfully defend the first appeal but then lose the second. The first appeal would not, therefore, remove the need for the CC to consider the issues in the second appeal stage

<sup>14</sup> Should the modifications not result in benefits to consumers, there would be an expectation that Passenger Focus, the licensee or the Secretary of State would trigger a successful appeal.

<sup>15</sup> The initial judicial review of the CAA’s Gatwick decision took 15 months to complete and then was subject to further consideration by the Appeal Court.

therefore, be considered by the CAA in proposing any change and by the CC in hearing any appeal.

- 2.28 The picture is somewhat different under the ‘derogations approach’, where passing the supplementary tests allows the CAA to introduce the licence obligations (by way of lifting the derogation) but only to be subject to an adjudicative appeal. In this way, the use of the supplementary tests might increase the CAA’s ability to ‘switch on’ the full ring-fencing conditions. As discussed above, the clarity of this proposal would be improved by replacing these tests with a reference to the CAA’s statutory duties.
- 2.29 However, in the event that the CAA considered it necessary to modify the licence conditions before they were ‘switched on’, the derogations approach would follow a similar process to that described above for the licence modification approach: namely two different tests with two different appeals processes. A simpler approach would be to apply the combination of a supplementary test and an adjudicative appeal only to those instances where the CAA considers that the licence conditions should be brought into effect as originally drafted in the initial licence. If the CAA wishes to modify the conditions in any way, then this should be dealt with under the standard licence modification process, which has a single, investigative appeal process. In doing so, the process would be streamlined, without reducing the rights enjoyed by interested parties to appeal.
- 2.30 This approach might also simplify the implementation of any legislation, as there would be no need to define the “financial licence conditions” in legislation. Instead, the adjudicative appeals process would apply to the lifting of any derogations issued by the Secretary, whilst any licence modifications – including to conditions subject to derogation – would attract an investigative appeal. In both cases, the CC would consider whether the proposed change was consistent with the CAA’s statutory duties.

#### Additional implementation and ongoing costs

- 2.31 The DfT’s proposal would prompt the CAA incur costs in order to provide sufficient clarity about the CAA’s interpretation of the ‘supplementary tests’. There would also be additional costs associated with any financial licence modification, including costs associated with the additional appeal processes.
- 2.32 The CAA’s estimates of the costs that it would incur are set out in Table 2 below, together with a short explanation of the rationale for the cost estimates.

**Table 2 Cost estimates for implementing the ‘supplementary tests’ (CAA costs only)**

Cost item	Estimate	Notes
Providing guidance on the interpretation of the ‘supplementary tests’ (one-off cost)	<i>Internal costs:</i> 25-75 working days ≈ £12.5k - £37.5k <i>Consultancy cost:</i> Circa £25k	- To cover drafting consultation and decision documents, together with governance processes <sup>16</sup> - Additional external costs arise due to need for external legal review
Preparation, consultation and decision on whether ‘supplementary tests’ are met (cost incurred each time licence modifications are proposed)	<i>Internal costs:</i> 40-80 working days ≈ £20k - £40k  <i>Consultancy cost:</i> Circa £10k	- To cover drafting consultation and decision documents, together with governance processes (underlying analysis is assumed to be common to the analysis of whether proposals meet the statutory duties) - Additional external costs arise due to need for external legal review
Cost of ‘adjudicative’ appeal of whether ‘supplementary tests’ are met (incurred each time appeal is triggered)	<i>Internal costs:</i> 50 -100 working days ≈ £25k - £50k  <i>Consultancy cost:</i> £250k – £500k	- Internal costs to prepare defence, attend hearings and liaise with legal advisers - External legal costs assume that a judicial review or referral to the appeal court is not triggered

Source: CAA cost estimates

### The potential for perverse outcomes

- 2.33 The consultation document refers to the potential for the “switch on” mechanism to result in a cost associated with different airports within Tier 1 being subject to different financing licence obligations. The CAA considers that the individual licences within Tier 1 should be tailored to the individual circumstances of each airport. Consequently, the fact that the licences would differ is not, in itself, a cost and could be a benefit.
- 2.34 However, the potential perversity of the proposed mechanism<sup>17</sup> is that it might result in airports that improve their finances being subject to a greater degree of financial regulation, as airports with finances that can sustain a full ring-fence would be more likely to pass the proposed cost-benefit test. This would run contrary to the principles of Better Regulation.

### Benefits

- 2.35 The DfT’s draft impact assessment argues that the proposed ‘switching on’ mechanism is likely to “increase certainty of the circumstances in which the removal of the initial derogations could occur, which would facilitate ongoing investment, which is in passengers’ interests in the long run.”<sup>18</sup>

<sup>16</sup> Governance processes would include senior review, policy committee meetings and, where appropriate, board meetings to approve publications and decisions.

<sup>17</sup> This concern would apply under both the ‘derogations’ and ‘licence modification’ approaches.

<sup>18</sup> DfT Impact Assessment, December 2009

- 2.36 For the reasons set out in the preceding section, the CAA does not agree that the proposal adds to certainty. Rather, the proposal to introduce supplementary tests would undermine the clarity established by the proposed statutory duties and provide airport licensees with a tool to delay the introduction of modifications that further the CAA's statutory duties.
- 2.37 More generally, if the proposal follows the 'licence modification' approach it appears to reduce the likelihood that the CAA would be able to move an airport to a full ring-fence, which would undermine any benefits associated with the introduction of such a ring-fence. For this reason, the proposal would act against, rather than help to achieve, the DfT's stated objective to move to a full ring-fence "as soon as appropriate".
- 2.38 In contrast, if the proposal follows the 'derogation' approach – amended to bring the supplementary tests into line with the statutory duties – it could facilitate the introduction of the full financial ring-fence.
- 2.39 More generally – as argued above – the statutory duties, supplemented by the appeals regime, provide sufficient protection to airport licensees against any premature or unjustified introduction of ring-fencing conditions. Consequently, the CAA does not agree with the argument put forward in the Impact Assessment that the absence of the supplementary tests may "possibly impede ongoing investment". The statutory objectives make specific references to "future consumers" (in the primary objective) and, in the supplementary duties, to the ability of licensees to finance their activities and the need to meet "all reasonable demands". Ensuring that there are appropriate investment incentives is, therefore, central to the achievement of the CAA's objectives, providing considerable comfort to airport licensees and providers of finance. The appeals regime provides a further protection to licensees and providers of finance, extending the appeal right beyond judicial review and providing the licensee with the ability to trigger an extensive appeal. These protections would provide sufficient assurance that the CAA would not undertake actions that would inappropriately "impede ongoing investment".
- 2.40 It would, therefore, be open to the DfT not to introduce any specific mechanism of derogations and instead rely upon the CAA's proposed statutory duties to future consumers. This reference in the primary objective would provide the CAA with a clear locus to take proper account of the effects on efficient and economic investment, and thus should provide sufficient comfort to airport owners.

## CAA recommendation

### *Overall recommendation*

- 2.41 Whilst the benefits of introducing a full ring-fence at each of the Tier 1 airports are unclear<sup>19</sup>, it appears that the DfT's proposal would have the effect of unduly limiting the ability of the CAA to introduce a full ring-fence, preventing it from realising any gains that might result. The introduction of supplementary tests, which differ from the statutory duties, will also reduce, rather than add to, the clarity of the overall regime.
- 2.42 The CAA recommends that the DfT place reliance on the combination of the proposed statutory duties and the proposed appeals regime, rather than implement the proposed mechanism (i.e. Option 1). These statutory duties are clearly framed to protect the interests of current and future consumers and therefore mean that the CAA will consider the impact of its decisions on the finances of airport operators and any consequent impacts on consumers' interests, such as adverse impacts on investment. Further, to the extent that the CAA fails to demonstrate that a change is in consumers' interests, the airport would be able to trigger an appeal to the CC (for a full, investigative appeal).
- 2.43 If the DfT considers that a 'switching on' mechanism is required, the CAA recommends that:
- the DfT follows the 'derogations' approach;
  - that the supplementary tests be replaced by a reference to the CAA's statutory duties; and
  - in the event that any modifications are needed to the licence conditions covered by a derogation, that these be treated as a proposal to introduce a new condition and follow the standard licence modification process.

### *Response to consultation questions*

#### **Q.5 Do you agree that for the removal of initial derogations there should be a supplementary test for the regulator to consider?**

- 2.44 For the reasons set out above, the CAA does not support the supplementary test as it appears likely to result in additional costs without any additional benefits.

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<sup>19</sup> The factors affecting the net benefits associated with ring-fencing licence conditions are discussed in more detail in the CAA's response to the DfT's March 2009 consultation (see chapter 2 of <http://www.caa.co.uk/docs/5/ergdocs/20090522FrameworkEcRegCAA.pdf>).

**Q.6 Do you agree that the proposed supplementary test consisting of a material change in circumstance and cost benefit analysis would achieve the DfT's objective outlined in paragraph 19?<sup>20</sup>**

2.45 Paragraph 19 refers to the objectives set out in the Ministerial Statement of the 13 October 2010. This statement refers to the objective to introduce a full ring-fence and the objective of only doing so when the benefits outweigh the costs.

2.46 As discussed above, the supplementary test would act against the first of these objectives, whilst the proposed statutory duties and appeals mechanism would secure the second. Consequently, the proposed supplementary tests do not contribute to the achievement of the stated objectives.

**Q.7 If you disagree what alternative would you suggest that meets the DfT's objective, and why?**

2.47 As discussed above, the DfT should place reliance on the proposed statutory duties and appeals processes, which provide a clear and effective mechanism to develop the licence in accordance with consumers' interests.

**Q.8 Do you agree that appeals of a decision by the regulator as to whether the conditions for removal of the initial derogations have been satisfied should be to the Competition Commission on an adjudicative basis and that the parties who should be able to appeal are the regulated company, Passenger Focus and the Secretary of State?**

2.48 As discussed above, the additional appeals process has the effect of delaying a licence modification, rather than affording any party the right to trigger more detailed scrutiny. This is because the proposal would add to, rather than replace, the standard appeals process. Consequently, the CAA does not support the introduction of a further appeals mechanism. It would unnecessarily duplicate protections that have already been proposed.

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<sup>20</sup> The consultation document refers to "Paragraph 9", but it appears that this reference should be to paragraph 19.