

Regulatory Policy Group
Economic Policy and International Aviation



APD Consultation
2/N1
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

17 June 2011

Dear Sir/Madam

REFORM OF AIR PASSENGER DUTY: A CONSULTATION

I attach the response of the Civil Aviation Authority to the above consultation.

Yours faithfully

A handwritten signature in blue ink, appearing to read "Trevor Metson".

Trevor Metson

HM TREASURY CONSULTATION ON REFORM OF AIR PASSENGER DUTY

RESPONSE BY THE CIVIL AVIATION AUTHORITY

Key points

- The CAA favours as simple an Air Passenger Duty (APD) system as possible which minimises distortions, perverse incentives and other unintended consequences.
- We understand the fairness motive for extending APD to passengers on ‘business jets’, but the potential impact on other types of passenger should be re-assessed, and further discussion is needed as to how to prevent the proposals being expensive and burdensome to administer.
- Reducing the number of bands from four to two would simplify the scheme and remove some anomalies of the four-band system.
- There is some logic to bringing Premium Economy into the reduced rate band in the interests of maintaining consumer choice, even though it would make the scheme more complex to administer.
- The Government is seeking views on the desirability of differentiating APD between UK airports, including through devolution. To the extent that an air service brings to a UK region significant economic benefits which do not form part of an airline’s decision-making, there could be a case for encouraging such services through some sort of carefully targeted intervention against clear policy objectives. However, before contemplating intervention, the CAA suggests that the Government should have a broader policy discussion and consider what tools are available. We are concerned that introducing significant differentials in APD could risk creating unintended consequences and additional complexity.

Introduction

1. The Civil Aviation Authority (CAA) is the UK’s specialist aviation regulator. Through its skills and expertise it is recognised as a world leader in its field. Its specific responsibilities include air safety, economic regulation, airspace regulation, consumer protection and environmental research and consultancy.
2. The interests of the consumer are central to all of the CAA’s work: in safety, in market regulation and consumer protection, and in terms of the impact of aviation on the environment. The CAA ensures that UK civil aviation standards are set and achieved; regulates airlines’, airports’ and National Air Traffic Services’ economic activities and encourages a diverse and competitive industry; manages the UK’s principal travel protection scheme (ATOL); licenses UK airlines and manages consumer issues; and brings civil and military interests together to ensure that the airspace needs of all users are met as equitably as possible. In addition, the CAA advises the Government on aviation issues, represents consumer interests, conducts economic and scientific research, produces statistical data and provides specialist services.

3. In this response the CAA draws on its expertise to give independent advice on the options and questions set out in the consultation document about specific aspects of reforming APD.
4. Our response is structured as follows:
 - **Introduction**
 - **Government objectives for APD**
 - **Responses to consultation questions (a) to (e)**
 - **Technical attachments:**
 - Attachment 1:** Aircraft on UK register with a maximum weight between 5.7 and 10 tonnes
 - Attachment 2:** Examples of scheduled air services using aircraft with a maximum weight between 5.7 and 10 tonnes from UK reporting airports in 2010
 - Attachment 3:** CAA experience in advising on the implementation of the EU Emissions Trading System for aviation
 - Attachment 4:** CAA response to 2007 APD consultation on class of travel
 - Attachment 5:** Cabin classes and fare overlaps
5. Where possible, we have sought to highlight the trade-offs between:
 - ensuring that the APD scheme achieves its stated objectives
and
 - ensuring that:
 - there is a minimum of market distortion
 - the burden on the industry is minimised in line with 'better regulation' principles; in particular that the solutions are proportionate and transparent.
6. We would be happy to meet with HM Treasury to discuss any points in our submission in more detail. Please contact:

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Government objectives for Air Passenger Duty

7. The consultation document (paragraph 1.4) summarises the Government's objectives for APD as:
- a simple tax system for air transport services in the UK that does not hamper growth;
 - ensuring a fair contribution towards the public finances from the sector; and
 - ensuring that it is consistent with reducing emissions across all parts of the economy.

A simple tax system for air transport services that does not hamper growth

8. The CAA notes that the Government is seeking comments on simplifying APD into fewer distance bands. We also note that there are already extensive HMRC rules required to make the current system work. The global nature of the industry means that more complex passenger itineraries can involve multiple airlines, classes of travel and currencies worldwide, and the reservation systems that facilitate this must be able to cope with any changes. We therefore fully support the Government's intention not to add unnecessarily costly and complex administrative and compliance burdens on the industry and consumers who will ultimately bear the associated costs.
9. However, the CAA notes that alongside the proposal to simplify the existing APD bands, the other proposals would actually increase the complexity in the administration and enforcement of APD by creating a specific scheme for smaller and privately operated aircraft, introducing a seat metric to distinguish between premium products, and/or creating regional variations in APD. While we recognise that these changes are intended to reduce some of the perceived unfairness associated with the current APD regime, care should be taken to ensure that the benefit associated with such moves is not achieved at the cost of disproportionate levels of burden on industry and consumers.
10. The consultation document highlights the importance of a strong and healthy aviation sector to the UK economy. The connectivity that aviation provides facilitates economic activity and growth¹ by giving UK businesses access to international markets as well as offering UK consumers greater choice of goods and services. While it is right that the aviation sector should contribute to the public finances, the CAA is committed to promoting choice and value for consumers. An APD regime which minimises the loss of routes and connectivity will best meet the Government's objective of not hampering growth.
11. The economic downturn has had a severe impact on the industry. UK airports handled 210 million passengers during the 2010 calendar year, a fall of 3.4 percent (7.4 million)

¹ The role of air travel as an important feature of international trade and economic development is explored in two recent CAA reports on business air travel: *UK Business Air Travel: traffic trends and characteristics*, CAA May 2009, and *Flying on Business, a study of the UK business travel market*, CAA, December 2010. www.caa.co.uk/docs/5/ergdocs/20090515BusinessTravel.pdf
www.caa.co.uk/default.aspx?catid=589&pagetype=90&pageid=11877

on 2009. The UK's fragile recovery is not yet driving increases in passenger numbers. Passenger numbers have fallen for the last three consecutive calendar years, and were lower in 2010 than in 2004. Although the decline in business travel levelled out in 2010, leisure travel continued to fall. (Even if 2010's exceptional events are excluded – snow, strikes and volcanic ash – passenger numbers overall would still only have been likely to have equalled 2009.) Although airports in the South East were less affected, airports in the rest of the UK suffered significant falls in passenger numbers, with some now facing financial challenges as a result. Airlines have in the main coped well with unprecedented drops in passenger numbers, increasing load factors and sustaining margins where possible. Overall, the outlook for aviation is still uncertain. A return to robust economic growth should see increased passenger numbers, but this will be affected by other costs that bear on the sector, such as high oil prices and taxation, and by the availability of capacity. Congestion in the South-East could lead to more customers travelling to/from the UK using regional airports or other European hubs.

Ensuring a fair contribution towards the public finances from the sector

12. The consultation document states (paragraph 1.2) that a strong economy demands sound public finances and calls for a fair contribution from all sections of society. The CAA supports the principle that aviation should pay its fair share towards the maintenance of public finances. However, this should be seen against the background of the effects of the economic downturn on the industry and traffic levels, and the significantly higher rates of APD which have already been imposed in recent years.

Ensuring that APD is consistent with reducing emissions across all parts of the economy

13. While the aviation sector brings very significant benefits to the UK economy, as outlined in Section 2 of the consultation document, the CAA supports the Government's objectives for sustainable development and tackling climate change as outlined in Section 3 of the consultation document. The CAA agrees with the principle set out in the Government's March 2011 consultation *Developing a sustainable framework for UK aviation: scoping document* that the right balance must be struck between the economic, social and environmental costs and benefits of aviation: unconstrained growth of aviation is not an option, and growth in the industry should occur only where the economic and social benefits of aviation outweigh its costs.
14. The CAA notes that in order to help meet the environmental challenges facing the sector, significant steps have already been taken to incorporate aviation within the EU Emissions Trading System (ETS). The CAA supports this approach and agrees with the Government that EU ETS should be the principal mechanism for reducing aviation emissions. However, it is not clear whether the APD system is being designed to support these wider environmental goals or is simply seeking to raise revenue while avoiding any inconsistencies.

Consultation questions

(a) The Government plans to extend aviation tax to include 'business jets' on a per passenger basis for all qualifying flights with an authorised take-off weight in excess of 5.7 tonnes. The proposal is to have a single rate of duty per passenger in 2012–13, irrespective of distance travelled, equivalent to the highest standard rate of APD. Stakeholders are invited to comment on whether this proposal offers a fair and effective way of extending the APD regime to include passengers aboard 'business jets'. In particular, views are invited on the appropriate definition of 'business jets', the range of exemptions and expected market impact of the Government's proposals.

Summary of CAA response: APD should be as simple and as fair as possible. Therefore, in principle, we recognise the rationale for extending APD to passengers on 'business jets' on the grounds of fairness. However, the proposals appear inadvertently to sweep up passengers on other types of service where charging the highest APD rate is inappropriate. In addition, requiring every individual operator to register for APD seems to risk creating a disproportionate administrative burden on the industry and Government in collecting APD and enforcing the scheme. Some of these drawbacks might be minimised through the introduction of exemptions. We suggest that further discussions are needed around defining which passengers are to be brought into the scheme, how this would interface with the current APD scheme, and how collecting and enforcing the scheme would be managed. We can offer advice based on our experience of the EU Emissions Trading System.

15. The CAA supports the Government's objective that APD should be as simple and as fair as possible (paragraph 4.7 of the consultation document) and that any distortions in the market should be minimised. We therefore recognise the perceived unfairness that passengers on commercial flights are currently liable for APD, whereas those on non-commercial flights – which could include company executives travelling on business on a corporate aircraft – are not.

Definition of 'business jets'

16. There is no mention of the passenger seat de minimis limit in question (a), but it is assumed from the consultation document (paragraph 4.11) that the intention is to remove it. This means that APD would be extended to passengers carried:

- for reward in aircraft in the 5.7 to 10 tonnes maximum weight bracket;
- for reward in aircraft over 10 tonnes with fewer than 20 seats; and
- privately in all aircraft over 5.7 tonnes (if this option is adopted)

all of which were previously exempt. These options are amalgamated and compared with the current position in Table 1 below.

Table 1

Based on 2011 rates

		1	2	3
		5.7 to 10t	>10t, <20 seats	>10t, >20 seats
1 for reward	Current	exempt	exempt	£12 to £170
	Proposed	£170	£170	£12 to £170
2 not for reward	Current	exempt	exempt	exempt
	Proposed	£170	£170	£170

17. In terms of amending the weight threshold, the de minimis threshold of 5.7 tonnes maximum weight would be consistent with the approach taken for aircraft certification (i.e. design approval) and continuing airworthiness (i.e. the management and performance of aircraft maintenance by organisations), as well as that for the Emissions Trading System (ETS). By contrast, the current 10 tonne threshold fits better with the EU (and therefore UK) Operating Licence scheme. The CAA grants two types of Operating Licence, Types A and B. The EU Air Services Regulation (1008/2008) provides that operators using aircraft with fewer than 20 seats and/or below 10 tonnes maximum take-off weight qualify for simplified licensing requirements, and the CAA would grant such operators a Type B licence.
18. For the purposes of illustration of the aircraft types affected, Attachment 1 lists a snapshot as at April 2011 of the 180 aircraft² on the UK register which fall between 5.7 and 10 tonnes maximum weight (ignoring any seat de minimis limit). Around two thirds are aeroplanes, and one third helicopters. Just under half are types which might be expected to be used by business aviation or for air taxi charters.³ The other half includes helicopters used in the North Sea, regional turboprop airliners used on scheduled services, and a number of historic ex-military aircraft. Of course, APD would also apply to foreign-registered aircraft within this weight band departing from a UK airport.
19. Removing the de minimis seat limit would mean that more aircraft exceeding 10 tonnes (or rather their passengers) would qualify for APD than is the case today. This is because although there are many executive jet aircraft over 10 tonnes, most have fewer than 20 seats. As an indication, an analysis of UK departures by executive jet aircraft with fewer than 20 seats in a single day in early May 2011 revealed approximately 100 flights

² Not all may be active.

³ An air taxi could be defined as the charter, on demand, usually for sole use, and usually of a relatively small aircraft (CAA airport statistics use a definition of 15 tonnes maximum weight or less) for the purposes of carrying passengers or cargo – often between points not served by scheduled airlines. See also the report of the Strategic Review of General Aviation carried out by the CAA jointly with Government and representatives of the General Aviation community, for example page 5; www.caa.co.uk/docs/33/StrategicReviewGA.pdf.

conducted by aircraft over 10 tonnes (around 60 being non-commercial), compared with around 70 (20 non-commercial) by aircraft between 5.7 and 10 tonnes.

Market impact

20. There appear to be a number of issues or uncertainties raised by this proposal which could impact the market and which the Government will need to consider further.

These can be grouped as follows:

- (a) **Aircraft other than ‘business jets’:** As explained above, the new category of aircraft would include more than just ‘business jets’. For example, the scheduled helicopter service to the Isles of Scilly is operated with the Sikorsky S-61N, which is 9.2 tonnes. There are many other examples of scheduled services using aircraft in this weight band where, under this proposal, APD would now apply. A list of example services is at [Attachment 2](#). APD would also apply to air-taxi charters, and to passengers of North Sea helicopter operators, which fly to, from and between offshore platforms (both stationary and mobile). See also (e) below.
- (b) **Passengers on aircraft between 5.7t and 10t could pay more APD than those on aircraft over 10t:** Paragraph 4.12 of the consultation document proposes a blanket rate of APD for the new category of aircraft set at the highest standard rate of APD (£170 at 2011 rates). Passengers carried for reward on an aircraft between 5.7 and 10 tonnes could therefore pay more APD than those on a much heavier aircraft over 10 tonnes even where travelling to a closer destination (see row 1 of Table 1 above). The rationale for this is not clear from the consultation document, but is presumably linked to the statement in Annex B that ‘business jets’ carry “relatively high income employees or business people”. The CAA assumes that it was not the Government’s intention to apply such a high level of APD to commercial services using aircraft other than ‘business jets’ of 5.7–10 tonnes, as this would be completely disproportionate to the fare. For example, the return fare on the Isles of Scilly helicopter service ranges from £99 to £179, whereas £340 APD would be payable (£170 in each direction at 2011 rates). The Government may also wish to explore further with air taxi companies whether their customers are predominantly “relatively high income employees or business people” or whether they also carry other types of employee, or common-interest groups, who simply need air transport where other alternatives are not practical or available – such as between points not served by scheduled airlines.
- (c) **Passengers not carried for reward:** Paragraph 4.13 of the consultation document seeks views on extending APD to passengers not carried for reward. Annex B states that the majority of passengers on ‘business jets’ are travelling on behalf of major corporations and large businesses. However, the Government may wish to explore with the General Aviation community whether there may be some passengers on aircraft exceeding 5.7 tonnes who are neither carried for reward nor travelling on business – perhaps a private owner using the aircraft on occasion as a means of personal transport, and who may take friends or family as passengers.

- (d) **Higher APD rates for ‘non-commercial’ than ‘commercial’ passengers:** The option in paragraph 4.13 of the consultation document to extend APD to passengers not carried for reward, coupled with the proposal in paragraph 4.12, would mean that passengers on aircraft over 10 tonnes/20 seats could be charged a higher rate of APD dependent solely on the flight being non-commercial (since the current APD system would continue for commercial flights with aircraft over 10 tonnes/20 seats – see column 3 of Table 1 above). This would occur only where passengers were carried on an aircraft over 10 tonnes/20 seats but not for reward, for example a company aircraft operation.⁴
- (e) **Exemptions:** As a general principle the CAA would support, on the grounds of fairness, that all flights above a suitable threshold should be liable for APD. However, to the extent that ‘essential services’ are caught (paragraph 4.14 of the consultation document), the CAA would agree that there may be a case for specific, transparent exemptions – particularly where such flights would have to recover APD costs from public funds anyway. In addition, there may be a case for exemption where there is evidence that a certain class of flight brought within the scope of APD would create administrative burdens on the Government and/or on the operators concerned which are disproportionate to any revenue (or environmental) gain, in line with ‘better regulation’ principles. ETS includes exemptions to address similar issues. In the interests of minimising impact, the Government may wish to consider whether any APD reform should mirror the ETS exemptions, with the exception of the de minimis provisions. We have provided more detail in [Attachment 3](#). It should be recognised that any exemptions could themselves increase administrative complexity and create perverse incentives.
- (f) **Administration and enforcement:** We would draw attention to the CAA’s general experience in advising on ETS⁵ (we have provided more detail in [Attachment 3](#)). Much of our work in this area has been focused on the obligations placed by ETS on the multitude of smaller non-commercial operators which are not covered by ETS de minimis provisions.⁶ The Government should therefore recognise – as suggested by Annex B of the consultation document – that there may be a considerable and expensive administrative burden created if the current arrangements for collecting APD were to be extended to passengers on such flights, given that many operators of business aircraft fly to the UK relatively infrequently and carry few passengers.⁷ The CAA has found that in some circumstances it can be time-consuming to establish the

⁴ Of course, the current position is not ideal either in that the commercial flight would attract APD whereas the non-commercial flight would not.

⁵ The CAA has a statutory role as adviser to the UK’s environment agencies in respect of the entry of aviation into EU ETS.

⁶ EU ETS includes de minimis provisions for commercial operators in respect of emissions and where operating fewer than 243 flights at an EU airport in each of three consecutive four-month periods.

⁷ The current APD rules require an operator to register for the purposes of APD even for a one-off flight (HMRC Notice 550, section 5.7). There would, therefore, seem to be a risk that by widening the scope of APD to include private operators, an operator would have to register even for carriage of a single passenger on a one-off flight.

operator of a particular non-commercial flight, which could make it difficult to trace operators who have failed to comply with APD requirements.

Given these difficulties, we suggest that the Government considers ways to simplify the collection of APD for passengers on 'business jets'. Options that might be considered are exempting operators below a de minimis number of flights per year, simplifying remittance to an annual return, or finding a workable means of collecting APD from passengers on 'business jets' through airport charges schemes.

(b) The Government proposes two alternative models for simplifying APD. The first (consultation option 1) is based on two bands. The boundary between bands A and B could be delineated at a distance of 2,000 miles. The second model (consultation option 2) is based on three bands, with a distance boundary delineated at 2,000 miles and 4,000 miles. In both cases, alternative boundary delineation based broadly on the EU/EEA/ECAA and the rest of the world will be considered. Stakeholders are invited to comment and provide relevant evidence on the impact of a move to either of these models of APD from April 2012.

Summary of CAA response: The main consideration should be to minimise the distortions created at the boundary between bands while ensuring an administratively simple scheme. This points to reducing the number of bands from four to two (option 1).

21. In terms of the two options 1 and 2 outlined in the question, the CAA's preference would be for the option which minimises the distortions at the boundary between bands in terms of their impact on the aviation sector and the wider economy, while ensuring an administratively simple scheme.
22. A greater number of bands means that APD is likely to be better aligned in terms of percentage of ticket price; broader bands tend to favour longer routes. However, the more boundaries, the more potential anomalies are created when points of similar distance fall in different APD bands. Moving to fewer bands has the advantage of administrative simplicity, but is likely to mean a wider differential between rates in each band potentially exacerbating any existing anomaly (Tables 4B and 4C in the consultation document).
23. On balance, the CAA's preference would be for the simpler system of option 1. We would agree that 2000 miles is a suitable threshold as it gives as good a division as could be expected between routes traditionally served by short-haul and by long-haul configured aircraft, accepting that there are likely to be some overlaps on medium-haul routes. For this reason the 2000-mile boundary seems marginally better than one based on EU, EEA or ECAA countries which would change over time, unless there are convincing single-market arguments to the contrary. If the Government decides to pursue alternative options of three or four bands, one option to reduce distortion

effects might be to look at ways of dividing North America into two bands in the same way as Russia is at present, assuming this could be done simply and transparently.⁸

(c) The Government invites comments and relevant evidence on how the current class distinction in APD affects the market. Stakeholders are invited to demonstrate how any change could be achieved without significant additional compliance and administration burdens.

Summary of CAA response: The option chosen should be that which is likely to bring the consumer the most choice and avoids unintended consequences that might lead to that choice being artificially restricted. The CAA commented in detail on classes of travel in the 2007 APD consultation. In principle we support the argument that on long-haul services only Business Class and First Class passengers should pay the standard (higher) rate, given that these products are differentiated more clearly from the Premium Economy and Economy products and in the interests of minimising distortions in passenger choice. This would require the widespread use of a seat-pitch metric, and would presumably need to be confined to long-haul services only, unless the Government is content to see short-haul Business Class recategorised at the reduced APD rate. It would therefore inevitably be more complex to administer than the current scheme.

24. Different rates of APD for passengers travelling in different cabin classes can affect the way markets operate. The CAA's preference is that any market distortions are minimised whether this be, for example, in the choice the passenger makes between airlines or between products offered by a given airline. We can also offer views on whether it would be practical to adopt particular options.
25. The consultation document specifically invites comments on whether the APD rate in respect of Premium Economy Class passengers should be reviewed so as to reclassify Premium Economy as attracting the reduced rate, the same as Economy. In principle we support such a change, on the basis that the product (and therefore fare) differential on long-haul flights between Premium Economy and Economy is, in general, narrower than that between Business Class and Premium Economy. Airlines offering a Premium Economy product which is very close to the Economy product will therefore be most affected by the way the boundary between the reduced and standard APD rates is currently drawn.
26. The CAA wants to avoid APD causing unintended consequences that might lead to consumer choice being artificially restricted. It could therefore be argued that the boundary should be drawn so that only Business Class and First Class passengers pay the standard (higher) rate, given that these products are differentiated more clearly from the Economy products and in the interests of minimising distortions in passengers' choice between products.

⁸ Perhaps organised by state, using 4000 miles as the boundary, if this were easy to programme in reservation systems.

27. Premium Economy was introduced as far back as 1992 (by Virgin Atlantic), long before the reduced and standard rate distinction for APD was introduced in 2001. BA and bmi introduced Premium Economy in 2000.
28. There would seem to be several reasons why some stakeholders are now asking for this cabin to qualify for the reduced rate: the product has become more popular; it has evolved from a product aimed at business travellers who would otherwise have travelled in Economy⁹ into a product which is also attractive to leisure passengers, including those on charter flights, who are likely to be more price sensitive than business passengers even though they are buying a premium product; and because the differential between the reduced and standard APD rate on flights outside Europe has widened (in 2001 the difference was £20, while today it is between £60 and £85).
29. The CAA assessed options for bringing Premium Economy passengers into the reduced-rate APD band in our response to the Government's 2007 APD consultation on the definition of class of travel. Our conclusion was that it should be possible to achieve this reasonably effectively by using a seat-pitch criterion to differentiate between Premium Economy and Business Class on long-haul configured aircraft. This would depend on the ability of reservation systems to handle such a criterion on journeys involving connecting flights.¹⁰
30. This justification of a relatively limited product differential for moving Premium Economy Class on long-haul flights to the lower APD rate could, in principle, also be applied to the Business Class/Economy Class divide on short-haul flights.

⁹ See pages 123 to 126, *Flying on Business, a study of the UK business travel market*, CAA, December 2010 for a discussion of Premium Economy www.caa.co.uk/docs/589/ERG_FlyingOnBusiness_AStudyOfTheUKBusinessTravelMarket.pdf. Business traffic fell as a result of the economic downturn, but in 2009 Premium Economy was still attracting a significant proportion of business passengers – see Attachment 5 to this submission; indeed the subsequent tightening of company travel policies made Premium Economy a useful part of the proposition by airlines seeking to attract corporate customers. More airlines are introducing a Premium Economy cabin; the necessary planning lead times mean that this occurred too early to be attributed to the economic downturn. Attachment 5 also illustrates fare overlaps between Economy, Premium Economy and Business Class on a typical long-haul route.

¹⁰ In that the final destination determines the rate of APD where the passenger travels on through-ticketed connecting flights, so the second leg (i.e. not touching the UK) may be on an airline not serving the UK but whose seat pitch would, under this proposal, determine whether reduced or standard APD was paid.

31. There is an argument that the more that airlines unbundle their economy product and create a menu of charges for optional items¹¹ while remaining within the definition for the reduced rate of APD (HMRC Notice 550 paragraph 2.6.3), the less appropriate it is to apply a higher rate of APD where travel is in a separate cabin with a relatively modest product improvement.
32. In practice, the current positioning of the reduced/standard APD rates in the context of a two-class short-haul product is arguably less distorting of consumer choices than it is in the long-haul market. That said, it should also be recognised that there has been a dramatic fall in the use of short-haul Business Class, and reportedly greater price sensitivity, which is seen as a structural change in the market and not likely to recover after the economic downturn.¹² The Government will therefore need to consider whether it wishes to make this change only in respect of long-haul flights, because applying it to all flights would bring short-haul Business Class within the reduced APD rate. This then raises the question of how to distinguish between short and long-haul flights. The 2000-mile threshold discussed in question (b) above would be a reasonable, but not perfect, proxy.
33. More detail is set out in the CAA response to the Government's 2007 APD consultation, which is attached as Attachment 4 (the specific solution in that response is described as Option 1c). We have also included in Attachment 5 some context about the usage trends and an example of the range of fares available in the different cabin classes.

¹¹ The degree of unbundling varies between airlines. The principle is to reduce the base fare to a minimum, and to have a menu of value-added ancillary items that can be purchased for an extra charge (often items which airlines would once have bundled with the fare). This strategy also allows airlines wanting to differentiate their product from competitors to add optional frills for passengers requiring additional comfort, facilities or flexibility. These might include at-airport (rather than on-line) check-in, credit-card payment, no weight limit on hand luggage, hold baggage, points in a frequent-flyer programme, business lounge access, switching to earlier or later flights, priority boarding, advance seat allocation, extra leg room seat rows, and in-flight entertainment or catering. The concept has become widespread among no-frills airlines and a significant source of airline revenue. To a more limited extent, it has spread to some network airlines. The biggest impact has been on short haul routes and the Economy cabin (fares in premium classes tend to remain bundled), but it has resulted in significant changes in the way network airlines manage seat assignments and hold baggage allowances. Some airlines incorporate the extras (or offer them for an annual charge) for frequent flyers or as part of corporate deals.

¹² See Attachment 5 to this submission and pages 51 to 57 and 144 to 145, *Flying on Business*, referenced above.

(d) The Government invites comments and relevant evidence on the impact of APD on the UK's regional economies. Stakeholders are invited to demonstrate how any changes would promote more balanced economic growth.

(e) The Government invites comments and relevant evidence on the market impact of proposals to devolve APD in Scotland. Views and relevant evidence for devolving APD in Northern Ireland and Wales are also invited.

Summary of CAA response to both questions: In question (d) the consultation document invites views on the impact of APD on UK regional economies, and in question (e) it invites views on the market impact of devolving APD to Scotland, Northern Ireland and Wales.

The implication of these questions is presumably that APD might be differentiated between airports, whether by central Government or through devolution. However, the CAA notes that the consultation document makes no specific proposal, and only briefly explains the reasoning and policy objective for such a move.

If the Government believes that it is necessary to intervene in the market, then we suggest that it should initiate broader policy discussions around this proposal in order to consider the range of tools that may be available.

As the industry's economic regulator, the CAA's approach is generally to favour liberalisation and to rely wherever possible on market-driven mechanisms. To the extent that an air service brings significant economic benefits to a UK region which do not form part of an airline's decision-making, there could be a case for encouraging such services through some sort of carefully targeted policy intervention. If the proposal is to apply a blanket reduction in APD based on the departure airport's regional location but not based on other factors, this would not be a targeted approach. Depending on the definition of regional boundaries and the extent to which APD is differentiated, there could be a risk of creating the sort of unintended consequences and complexity that the Government, in framing the consultation document, has said that it wishes to avoid.

These arguments also apply if devolution were to result in APD being differentiated between airports, although we note that Northern Ireland already faces some market distortion from lower aviation taxation at Dublin, and devolution would give Northern Ireland the flexibility to rebalance local taxation to alleviate this.

34. In question (d) the consultation document invites views on the impact of APD on UK regional economies, and in question (e) it invites views on the market impact of devolving APD to Scotland, Northern Ireland and Wales. Our comments on these two questions are necessarily based on the assumptions that the Government is exploring the possibility of differentiating APD between airports, and that the result of regional

differentiation or devolution could be quite wide variations in APD – and therefore potentially final ticket prices – between airports across the UK.¹³

35. Consumers now have much more choice than in the past in terms of destinations, airlines and flight frequencies and they can easily substitute between various options available to them in response to price differentials. This is particularly the case on short-haul services, where the flight is largely considered a commodity and where there is a large number of routes and airlines to choose from. Unsurprisingly, there is clear evidence of passengers demonstrating significant (and increasing) sensitivity to price in their purchasing decisions in response to the widespread availability of alternatives¹⁴ with signs of greater price sensitivity apparent in the business as well as leisure market.¹⁵
36. A regional variation in APD therefore has the potential to generate competitive distortions between airports or regions, and brings a risk of creating the sort of unintended consequences and complexity that the Government, in framing the consultation document, has said that it wishes to avoid.
37. As the industry's economic regulator, the CAA's approach is generally to favour liberalisation and to rely wherever possible on market-driven mechanisms. Intervention in the market should be confined to instances where there is clear evidence of market failure, and it should have a clearly defined policy rationale. The CAA notes that the consultation document makes no specific proposal, and only briefly explains the reasoning and policy objective(s) against which the introduction of regionally differentiated APD should be assessed. The CAA believes that consideration of these questions would benefit from further clarity from the Government in defining the policy objective(s) that regional differentiation might be expected to deliver.
38. The CAA notes that the consultation document touches on several policy objectives that regionally differentiated APD might be expected to achieve:
- to facilitate economic growth in particular regions through the promotion of regional air services¹⁶;
 - to deal with excess demand at airports in South-East England by using higher levels of APD in that region as a form of scarcity tax;

¹³ Bearing in mind that although services from UK regional airports are dominated by short-haul, passengers flying to a European hub on a through ticket to connect to another flight will pay APD based on their ticketed final destination, giving the potential for a significant difference in monetary terms if APD were differentiated between airports.

¹⁴ *Demand for Outbound Leisure Air Travel and its Key Drivers*, CAA, December 2005.

www.caa.co.uk/docs/5/ERG_Elasticity_Study.pdf

¹⁵ In terms of the choice of airline and class of travel once the decision to travel has been taken, but also in the way volume discounts are negotiated. *Flying on Business, a study of the UK business travel market*, CAA, December 2010; see, for example, pages 51–52, 67–76 and 110.

www.caa.co.uk/default.aspx?catid=589&pagetype=90&pageid=11877

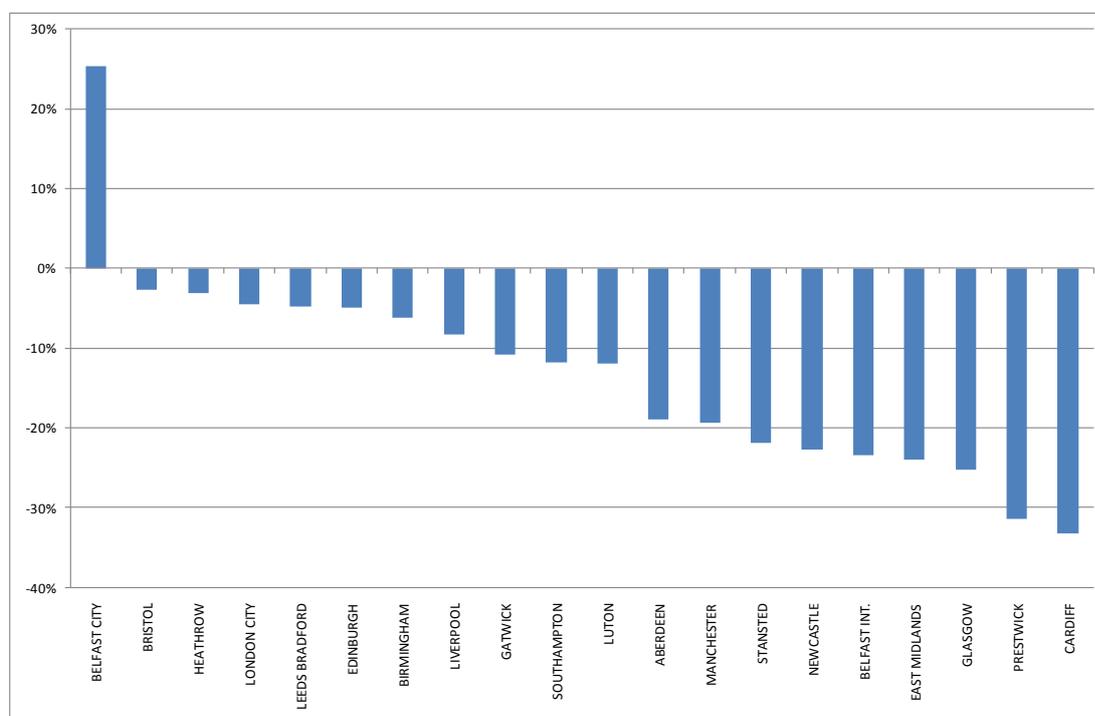
¹⁶ For convenience, the term 'regional' is used here to refer to airports outside the London area or air services to/from those airports.

- to broaden the tax base and degree of fiscal autonomy for the devolved governments (in the case of Scotland, in accordance with the recommendations of the Calman Commission).

To facilitate economic growth in particular regions through the promotion of regional air services

39. As noted earlier in this response, the recent economic downturn has affected traffic levels at UK airports significantly. The impact has varied considerably between airports. Of the 20 biggest UK airports in terms of passenger numbers in 2010, all but one (Belfast City) had fewer passengers in 2010 than in 2007. Heathrow and London City fared better over this period than most other airports, but the other three London airports fared less well (Figure 1). There are significant differences in traffic development both within and between regions.

Figure 1: Top 20 UK airports: change in passenger numbers 2007–2010



Note: Excludes Jersey

Source: CAA airport statistics.

40. As the economy emerges from the downturn, vigorous competition remains a clear feature across the regions, with UK consumers enjoying a wide range of choices in terms of destinations, airlines and airports. In the five years or so prior to 2007, there had been rapid growth at many UK airports¹⁷, in particular in international short-haul

¹⁷ See CAA airport statistics for more detail, for example Table 10.3 at www.caa.co.uk/docs/80/airport_data/2010Annual/Table_10_3_Terminal_Pax_2000_2010.pdf.

scheduled services. The CAA published two studies of UK regional air services in 2005 and 2007.¹⁸ Implicit in the findings was that, prior to the economic downturn, the market had delivered strong and sustained growth in regional air services. Despite the effects of the economic downturn, many of the new connections from regional airports remain in place. These include business as well as leisure destinations in Europe and further afield – including services to hub airports in Europe, the US and Middle East which allow numerous onward connections.

41. The reports also highlighted the increasingly more commercial approach of regional airports and that they had put themselves firmly on the map as gateways for travel to and from the areas of the UK they serve. Varying the rate of APD at the airport level – whether this be all airports outside the South East or airports in Scotland, Northern Ireland or Wales – may have competitive consequences for individual airports or airlines flying from those airports, causing a distortion in the market. This is not just because different APD rates could apply from neighbouring airports¹⁹, but also because airports are in competition across the UK, Europe, or even further afield to attract airlines looking to deploy new capacity. This would give some airports an advantage, because an airline's decision will take into account the fares they will have to charge as well as the likely level of local demand.²⁰
42. In terms of question (d), there may be practical difficulties in defining fairly where the boundary should lie. It should also be recognised that some UK airlines are largely London-based and have few services operating from regional airports.
43. In general, a lower rate of APD at airports in specific regions is likely to result in a shift of passengers geographically only where there is a realistic choice between airports.²¹ For

¹⁸ CAP754 *UK Regional Air Services: a study by the Civil Aviation Authority*, CAA February 2005, and CAP775 *Air Services at UK Regional Airports: an update on developments*, CAA, November 2007. See, for example, Figures 1 to 4 in CAP775. The studies also touch briefly on the link between regional economic development and air services (Chapter 1 of CAP754 and the Introduction to CAP775).

¹⁹ In principle, the economics of optimal taxes point to taxing inelastic demand. However, the price elasticity of demand varies according to how broad the price increase is. If the price increase is at the level of a particular airline or airport, passengers have the choice of travelling with a different airline, from a different airport, to a different destination, or not to travel at all. If the price increase is applied more broadly (to all airlines, airports, destinations), then the alternative choices will also have increased in price, and the elasticity faced by the airline or airport will be closer to the market elasticity, which is the elasticity reflecting whether a passenger, faced with a price increase, decides not to fly. Therefore the own price elasticity of demand faced by a particular airport can be substantially greater than the UK-wide elasticity of demand. In 2007, an InterVISTAS report prepared for IATA found that national level price elasticities of demand (-0.8) were much smaller than city-pair price elasticities of demand (-1.4). *Estimating Air Travel Demand Elasticities*, InterVISTAS, 2007, www.iata.org/whatwedo/Documents/economics/Intervistas_Elasticity_Study_2007.pdf

²⁰ It could be argued that APD already puts UK airports at a disadvantage relative to airports in other countries with a lower tax burden, and that a reduction in APD would at least help to redress this for the UK airport concerned. This argument would perhaps be strongest in respect of Northern Ireland where passengers can drive to the Republic of Ireland relatively easily. Nevertheless, the distortion between UK airports benefiting and not benefiting from the reduction would remain.

²¹ Since passengers choose airports not only based on the relative fare differences but also based on the time taken and cost incurred in travelling to the airports.

example, CAA Passenger Survey data²² suggests that relatively few passengers resident in Northern England travel to Scotland to catch a flight. Conversely, the survey suggests that shifts would be expected elsewhere, for example, in Wales, given the proximity of Cardiff and Bristol airports and the greater propensity of passengers resident in either region to choose between the airports. The same is likely to be true in Northern Ireland, although in that case a reduction in APD seems likely actually to reduce any distortion which may currently be caused by the lower tax burden in the Republic of Ireland – and devolution would give Northern Ireland the ability to respond to any change in taxation in the Republic. (That consideration would need to be balanced against the wider distortions that could be created in terms of airports competing for new capacity, as outlined above.)

44. In considering the merits of regionally differentiated APD as a tool to aid regional development, it should be considered alongside alternatives such as Route Development Funds (RDFs). The two CAA studies on regional air services²³ drew attention to RDFs operating at various times between 2003 and 2007 in Scotland, Northern Ireland, Wales and North-East England which used carefully targeted, temporary injections of public funding to kick-start new air services that were assessed as likely to bring net benefit to the region's economic development. Financial support can have a range of undesirable effects, and therefore the CAA's view is that this sort of support should be used cautiously and against strict and transparent criteria. Nevertheless, in certain circumstances – for example if the market is reluctant to offer a new air service because of risk aversion or the lack of awareness of potential – local schemes such as RDFs, or forms of joint marketing, could be a preferable, less distorting approach than the blanket application of differential taxation, subject to complying with EU law on state aid. The financial support should be provided by those benefiting from the positive externalities arising from the air service (i.e. regional stakeholders) so that they can accurately price the value of the service and expose what they are truly willing to pay for.

To deal with excess demand at airports in South-East England by using higher levels of APD in that region as a form of scarcity tax

45. The consultation document (paragraph 5.8) records the view of some industry stakeholders that a lower rate of APD at regional airports would be a possible remedy for the imbalance between airports in the South East operating at or near full capacity, and persistent excess capacity at some of the UK's other main airports. This seems to be suggesting a form of scarcity tax to address congestion at airports in the South East. The concept would not be inconsistent with economic principles, although we would observe that, inter alia:

²² www.caa.co.uk/default.aspx?catid=81&pagetype=90&pageid=7640

²³ See Chapter 8 of CAP754 and Chapter 7 of CAP775, referenced above.

- ‘South East’ is too wide a definition, since it would include airports such as Luton and Stansted, which still have spare capacity, and also airports such as Manston and Southend which currently have very few commercial passenger flights²⁴
- international-to-international transfer passengers – representing a substantial proportion (24 percent²⁵) of passengers at Heathrow – are currently exempt from APD
- market forces mean that passengers already tend to pay higher fares at capacity-constrained airports.

46. The CAA would conclude that the policy rationale for grouping all South-East airports together on the grounds of congestion is weak. If the problem to be addressed is economic rents at Heathrow and Gatwick, then any taxation measure should be targeted at these airports specifically. The Government might also consider whether alternative measures are more suitable (such as a windfall tax, or tax on slots, etc).

To broaden the tax base and degree of fiscal autonomy for the devolved governments

47. It is outside the remit of the CAA as the UK’s aviation regulator to comment on the wider arguments for and against the devolution of tax-raising powers to the devolved governments.

48. However, we would note that all of the comments above relating to distortions in competition between regions would also apply to competition between airports and the nations of the UK, should devolution lead to a widespread divergence of APD rates.²⁶ That said, we note that Northern Ireland already faces some market distortion from lower aviation taxation at Dublin, and devolution would give Northern Ireland the flexibility to rebalance local taxation so as to alleviate this.

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June 2011

²⁴ See www.caa.co.uk/docs/80/airport_data/2010Annual/Table_03_2_Aircraft_Movements_2000_2010.pdf and www.caa.co.uk/docs/80/airport_data/2010Annual/Table_10_3_Terminal_Pax_2000_2010.pdf.

²⁵ CAA Passenger Survey, 2010.

²⁶ The current exemption for passengers departing from airports in the Highlands and Islands could be regarded as de minimis.

Aircraft on UK register with a maximum weight between 5.7 and 10 tonnes

These are listed in Table 1-1 overleaf.

As well as aircraft usually associated with business aviation and air taxi charters, such as the Beech 300, Cessna 525/550/560, Embraer 505, Falcon 10, Hawker 400 and Learjet 35/45, this weight band also includes:

- some turboprop aircraft used for regional scheduled services, such as the DHC6 Twin Otter, Beech 1900, Dornier 228, Fairchild Metro, Jetstream 31/32 and LET410 (not all of these types are on the UK register but may still operate to the UK)
- some larger helicopters, such as the Agusta AW139, Sikorsky S-61 and AS332 Super Puma
- some historic ex-military aircraft.

Table 1-1: Aircraft on UK register with a maximum weight between 5.7 and 10 tonnes

Aircraft type	maximum weight (kg)	no. on UK register
DHC-6 SERIES 310	5700	1
EMB-110 P1	5700	1
DHC-6 SERIES 310	5708	1
PERCIVAL P66 PEMBROKE C MK1	5897	1
CESSNA 550	6033	6
DH115 VAMPIRE MK55	6069	1
DH115 SEA VAMPIRE T11	6082	1
DH114 SEA HERON C MK1	6123	1
PERCIVAL P66 PEMBROKE C MK1	6124	1
WESTLAND WESSEX 60 SERIES 1	6168	1
WESTLAND WESSEX HC.MK2	6169	1
DORNIER 228-202K	6200	3
CESSNA 525B	6291	2
CESSNA 550	6395	4
AGUSTA AW139	6400	3
CESSNA 550	6577	5
ILYUSHIN IL-2	6577	2
TWIN PIONEER 3	6622	1
CESSNA 550	6713	10
DH112 VENOM FB1	6749	2
DH112 VENOM FB1	6750	1
DH112 VENOM FB MK1	6763	1
AGUSTA AB139	6800	2
AGUSTA AW139	6800	5
BEECH B300	6804	3
LOCKHEED T-33 SILVER STAR 3	6940	1
JETSTREAM 3102	6950	2
JETSTREAM 3108	6950	1
JETSTREAM 3102	6999	1
GLOSTER METEOR T7	7000	1
JETSTREAM 3101	7059	1
JETSTREAM 3102	7059	11
JETSTREAM 3103	7059	1
DH112 VENOM FB50	7080	2
DH112 VENOM FB MK1	7081	1
DH112 VENOM FB1	7081	1
CESSNA 560	7212	2
LIM-5	7272	1
JETSTREAM 3202	7350	3
CESSNA 560	7394	1
HAWKER 400A	7394	2
BEECH B300	7484	1
CESSNA 560	7543	1
NORTH AMERICAN F86A SABRE	7847	1
EMB-505	8150	2
LEARJET 35A	8165	2
SKYRAIDER AD4-NA	8165	1
LEARJET 35A	8301	2
GLOSTER METEOR NF11	8482	1
FALCON 10	8500	1
AS332L	8600	16
CESSNA 560XL	9072	12
CESSNA 560XL	9163	7
SIKORSKY S-61N	9299	9
SIKORSKY S-61NM	9299	1
AS332L2	9300	16
LEARJET 45	9525	3
LEARJET 45	9752	11
JETSTREAM 4100	9999	1

Source: UK Register of Civil Aircraft, 12 April 2011

Table 2-1: Examples of scheduled air services using aircraft with a maximum weight between 5.7 and 10 tonnes from UK reporting airports in 2010

Route	Operator
Barra-Benbecula	Loganair – see Note 1
Barra-Glasgow	Loganair – see Note 1
Belfast City-Isle of Man	See Note 2
Belfast City-Blackpool	See Note 2
Belfast City-Cork	See Note 2
Belfast City-Galway	See Note 2
Belfast International-Galway	See Note 2
Belfast International-Isle of Man	See Note 2
Benbecula-Stornoway	Highland Airways – see Note 3
Blackpool-Isle of Man	See Note 2
Bristol-Bremen	OLT
Bristol-Isles of Scilly	Isles of Scilly Skybus – see Note 1
Campbeltown-Glasgow	Loganair – see Note 1
Cardiff-Anglesey	See Note 2
East Midlands-Isle of Man	See Note 2
Exeter-Isles of Scilly	Isles of Scilly Skybus – see Note 1
Glasgow-Tiree	Loganair – see Note 1
Gloucestershire-Isle of Man	See Note 2
Gloucestershire-Jersey	See Note 2
Guernsey-Southampton	Blue Islands
Inverness-Stornoway	Highland Airways – see Note 3
Isle of Man-Anglesey	See Note 2
Isle of Man-Leeds Bradford	See Note 2
Isle of Man-Newcastle	See Note 2
Manchester-Billund	Sun Air
Newquay-Isles of Scilly	Isles of Scilly Skybus – see Note 1
Southampton-Isles of Scilly	Isles of Scilly Skybus – see Note 1
Southampton-Jersey	Blue Islands

Notes:

- (1) flights operated by DHC6 Twin Otter, some of which are just under and some just over 5.7 tonnes MTOW.
- (2) operated by Eurocontinental, Flightline, FLM Aviation, Jetstream Executive Travel or Vanair Europe; some or all are understood to operate using the Manx2 brand.
- (3) ceased trading.

This is not a comprehensive list because it excludes scheduled air services where neither airport reports relevant statistics to the CAA, for example helicopter services to the Isles of Scilly. The list also excludes routes with passenger numbers below 100 in order to remove diversions. Highlands and Islands services are included but services within the Channel Islands or between the Channel Islands and Isle of Man are excluded.

Source: CAA airport statistics

CAA experience in advising on the implementation of the EU Emissions Trading System for aviation

The CAA has a statutory role to advise the environmental regulators on the entry of aviation into the EU Emissions Trading System (ETS). There are parallels between aviation ETS, with its 5.7 tonne maximum take-off mass threshold, and the proposal in this consultation to reduce the APD weight threshold to 5.7 tonnes and remove the de minimis seating threshold. The following information sets out the CAA's experiences with EU ETS.

ETS de minimis thresholds

ETS has activity de minimis thresholds applicable to commercial air transport operators that operate either: fewer than 243 flights per period for three consecutive four-month periods; or flights with total annual emissions lower than 10000 tonnes of CO₂ per year. These thresholds remove a number of smaller commercial operators from ETS, particularly those based overseas that make few trips to Europe each year. However, they do not apply to non-commercial operators and as a result there are a large number of smaller operators in ETS. As far as UK regulated operators are concerned, these out-number commercial operators by approximately 10 to 1. In order to reduce the compliance burden, both for operators and regulators, the Commission has introduced reduced reporting requirements for non-commercial operators under the thresholds for commercial operators.

Exemptions

There are a number of exemptions applicable to ETS which are set out below. We have added some notes that may be relevant in the context of the Government's proposals for APD:

- flights performed exclusively for the transport, on official mission, of a reigning Monarch and his immediate family, Heads of State, Heads of Government and Government Ministers, of a country other than a Member State, where this is substantiated by an appropriate status indicator in the flight plan;
- military flights performed by military aircraft and customs and police flights;
- flights related to search and rescue, firefighting flights, humanitarian flights and emergency medical service flights authorised by the appropriate competent authority (*CAA note: care needs to be taken to ensure that only genuine flights matching the above conditions are exempted; for example there are many medical service flights, but not all could be classified as emergencies*);

- any flights performed exclusively under visual flight rules as defined in Annex 2 to the Chicago Convention (*CAA note: this means that only flights under radar control are included in ETS; this has the effect of excluding short flights at low altitude and means that a number of historic aircraft kept for display purposes are not included*);
- flights terminating at the aerodrome from which the aircraft has taken off and during which no intermediate landing has been made (*CAA note: again this means that a number of historic aircraft kept for display purposes are not included; it also excludes sightseeing/pleasure flights*);
- training flights performed exclusively for the purpose of obtaining a licence or a rating in the case of cockpit flight crew where this is substantiated by an appropriate remark in the flight plan, provided that the flight does not serve for the transport of passengers and/or cargo or for the positioning or ferrying of the aircraft;
- flights performed exclusively for the purpose of scientific research or for the purpose of checking, testing or certifying aircraft or equipment whether airborne or ground-based;
- flights performed in the framework of public service obligations imposed in accordance with Regulation (EEC) No 2408/92 on routes within outermost regions, as specified in Article 299(2) of the Treaty, or on routes where the capacity offered does not exceed 30,000 seats per year (*CAA note: Public Service Obligations (PSOs) are used to protect certain routes that are vital to the economic or social development of a region and that cannot otherwise sustain a commercial air service. The UK Government currently imposes PSOs on 25 routes in Scotland (involving the Northern and Western Isles) and one in Wales (between Anglesey and Cardiff). These routes are contracted to one carrier for a set period and are subsidised either by the devolved governments or regional councils. Although APD is already not payable on flights departing from airports in the Scottish Highlands and Islands, the Welsh route is currently only exempt because it is operated by aircraft under 10 tonnes maximum weight. Regulation 2408/92 has been superseded by Regulation 1008/2008.*)

Enforcement issue in Identifying operators

The CAA has found that in some circumstances it can be difficult to establish the operator of a particular non-commercial flight. This may become an enforcement problem for the Government should it be necessary to trace operators who have failed to comply with APD requirements.

Examples where difficulties may arise include the use of special-purpose companies and the management of aircraft by third parties. Management companies specialise in providing services on behalf of private aircraft owners: depending on the nature of the agreement the company will take day-to-day responsibility for the aircraft; in some cases the management company will add the private jet to its charter fleet and operate it on the days when it is not being used privately. In most cases we would consider the management company as being the operator of the aircraft for the purposes of ETS, but it is not always clear. In addition

there are companies that simply offer a "trip support" administrative service to private operators who otherwise keep the operational control of their aircraft.

Potential administrative burden

There are around 4500 names on the Commission list of operators allocated to Member States to be regulated for ETS within Europe²⁷. Around 1000 of these are allocated to the UK because the bulk of their emissions involves this country, and a good proportion of those allocated to other Member States will be likely to visit the UK at some point. However, any given business jet operator may fly to the UK relatively infrequently. By their nature, business aviation flights tend to carry relatively few passengers.

²⁷ Annex B of the APD consultation document states that the precise number of 'business jet' operators is unknown, but that 3200 operators submitted a flightplan for travel within Europe in 2009.

CAA response to 2007 APD consultation on class of travel

AIR PASSENGER DUTY: HMRC CONSULTATION ON THE DEFINITION OF CLASS OF TRAVEL

RESPONSE BY THE CIVIL AVIATION AUTHORITY

Introduction

1. The Civil Aviation Authority (CAA) is the UK's independent specialist aviation regulator. Its activities include economic regulation, airspace policy, safety regulation and consumer protection. Until recently the CAA's economic regulation functions included some limited regulation of air fares in markets where competition was constrained, and this expertise, as well as our knowledge of the aviation industry, has informed this response.

Summary of CAA views and general comments

2. The CAA agrees that it is important that the Air Passenger Duty (APD) system remains as transparent and simple as possible. We note that there are already many detailed accompanying HMRC rules required to make the current system work. The global nature of the industry means that more complex passenger itineraries can involve multiple airlines, classes of travel and currencies worldwide, and the reservation systems that facilitate this must be able to cope with any changes. We therefore fully support HMRC's intention not to add unnecessarily costly and complex administrative and compliance burdens on the industry. We also note that HMRC intends any changes to the APD system to be broadly revenue neutral. Against the background of these objectives, this response comments on the proposed changes to the system, and on the pros and cons of each option and the policy aim each is intended to achieve.

3. Taxes can affect the way markets operate. The CAA's preference is that any market distortions are minimised whether this be, for example, in the choice the passenger makes between airlines or between products offered by a given airline. The CAA recognises the apparent anomaly that passengers travelling on Business-Class-only flights pay an APD rate that is lower than that paid by either Business Class or Premium Economy Class passengers on flights with a choice of cabins. This anomaly has existed since 2001 when the dual rates were introduced. For example, Concorde passengers, as the consultation document acknowledges, paid the lower rates between November 2001 and October 2003, when Concorde was retired²⁸. However, we recognise that with the recent growth in Business-Class-only flights, the anomaly is now more prominent and it would seem reasonable to remove what is potentially a market distortion in the choice the passenger makes between airlines. In terms of minimum change, Option 3 would seem to deliver this.

4. However, the consultation document *also* invites comments on whether the APD rate in respect of Premium Economy Class passengers should be reviewed. The implication of the consultation document (for example in paragraph 2.17) is that Premium Economy could be reclassified so as to attract the same APD rate as Economy, on the basis that the product (and

²⁸ Concorde was out of service April to November 2001.

therefore fare) differential on long-haul flights between Premium Economy and Economy is narrower than that between Business Class and Premium Economy. It could therefore be argued that the threshold should be drawn so that only Business and First Class passengers pay the higher rate, given that these products are differentiated more clearly from the Economy products and in the interests of minimising distortions in passengers' choice between products.

5. While Premium Economy has been offered in the UK market since the early 1990s, it now represents a larger segment of the market and the impact of the APD rate is therefore more significant. Should the Government decide to address it, we give our views on Options 1 and 2 below. Our main concern is that any solution along the lines of Options 1 and 2 should be as transparent as possible, practical and not overly burdensome on the industry, and that it does not give rise to further anomalies.

6. While the argument about a relatively limited product differential (used in respect of moving Premium Economy Class on long-haul flights to the lower APD rate) could in principle be applied to the Business Class/Economy Class divide on short-haul flights, in practice the current positioning of the threshold in the context of a two-class short-haul product could be argued to be less distorting of consumer choices than in the long-haul market. There is a question, therefore, as to whether the seat-pitch threshold proposed by Option 1 would need to be limited to long-haul flights, as Option 1 could potentially bring short-haul Business Class within the lower APD rate.

7. We have confined our comments to the options presented in the consultation document. However, there could be variations to these options, such as limiting the changes to long-haul flights. There are also more fundamental changes which could be made to the APD system, such as introducing more bands of charges, and relating those bands to fare levels rather than to cabin class or on-board product, if HMRC's policy aims could not be met through the options considered here.

Factual context

8. We acknowledge that airline business models are changing in what is a dynamic industry. We offer some factual comments on the two products to which the consultation document specifically refers, Business-Class-only flights and Premium Economy Class. We would also caution that airline business models are likely to evolve further. Therefore HMRC will want to consider how robust any changes to the system will be in terms of future developments. For example, one such issue may be the growth of travel to "mid haul" destinations. Although for convenience we have referred here to short haul and long haul, we note that destinations currently qualifying for the lower rate of APD are those within the European Common Aviation Area or in EU candidate countries. This means that "mid haul" destinations of similar distance may fall in either the lower or higher rate APD band. In the last few years some of these have grown considerably in popularity as holiday destinations (eg Egypt, Turkey).

Business-Class-only air services

9. The Business-Class-only sector of long-haul scheduled air services is currently growing. This can be traced back to transatlantic services from continental Europe that began between 2002 and 2005. These services have been operated on behalf of Lufthansa, Swiss and KLM by PrivatAir, a specialist business-jet operator, using Boeing BBJ (737) or Airbus A319 narrowbody aircraft. In the UK the concept is still comparatively young, and represents a small proportion of the total market. Three scheduled, Business-Class-only carriers have begun operating between London and the US in the last two years, offering a product throughout the aircraft that is comparable to the premium cabins of traditional full-service operators, but with published fares that are significantly lower. Each

carrier has initially served one of the New York airports, but routes have also been opened to Washington and Las Vegas.

10. Eos airlines, a US carrier, began operating a daily service between Stansted and New York (JFK) in October 2005, using a Boeing 757-200 with only 48 seats (compared with a more typical two-class configuration of 170–180 seats). Eos increased its frequency to double daily in September 2006 and added a third flight for three days of the week in April 2007.

11. In November 2005 another US carrier, Maxjet, began services on the same route, using a Boeing 767-200ER with 102 seats (compared with a more typical two-class configuration of more than 200 seats). It is currently serving the route on a daily basis, except Saturday. In April 2006 Maxjet commenced Stansted to Washington, now being served five times a week, and in November 2006 began a twice-weekly service from Stansted to Las Vegas. Maxjet has announced that it will begin London to Los Angeles services and increase Las Vegas frequency later in the summer 2007 season.

12. In January 2007, a UK operator, Silverjet, launched a daily service between Luton and New York (Newark) using a Boeing 767-200ER fitted with 100 seats. It has announced an increased frequency, to a double-daily service effective from September 2007. Silverjet has announced its intention to extend its network to other long-haul destinations and has acquired further aircraft for delivery between now and March 2008.

13. CAA airport statistics show that the Business-Class-only carriers carried around 60,000 passengers between them on the London–New York route in 2006, compared with the 3.7m carried by Heathrow and Gatwick “traditional” carriers and 17m in the UK–US scheduled market in total. The CAA’s passenger survey shows that of the London–New York passengers, around 0.5m were travelling in First or Business Class²⁹, although the latest available survey data is for the calendar year 2005. This means the Business-Class-only carriers achieved a share of around 10% of this market segment (depending on the extent to which the market has expanded through passengers trading up to these new services from Economy or Premium Economy Classes). In 2007 the capacity offered by the Business-Class-only carriers in the London–New York market is likely to be 50% higher than in 2006. So in terms of numbers of passengers and therefore APD revenue, the Business-Class-only sector is relatively small, but growing. Meanwhile further transatlantic services have begun from continental Europe, and recent press reports suggest interest in the concept by airlines such as British Airways and Virgin Atlantic.

Premium Economy Class

14. The consultation document refers to this as a recent and growing concept (paragraph 2.5). We agree that the concept has been more widely adopted by other airlines, including charter airlines, in recent years, having been introduced by the main UK long-haul carriers some years ago. However, Virgin Atlantic has offered a Premium Economy product – originally known as “Mid Class” – since 1992. British Airways introduced its own Premium Economy product – “World Traveller Plus” – in 2000, and bmi announced its Premium Economy product on long-haul services the same year.

15. Premium Economy and Economy on-board products are not greatly different. However, the same could be said of Business and Economy on-board products on short-haul flights. For example, on many short-haul flights, Business and Economy Class seats are interchangeable (or convertible), with separation between classes provided by a movable cabin divider.

²⁹ The survey did not distinguish passengers travelling in the Premium Economy cabin.

Measuring seat pitch

16. The CAA does not retain records of seat pitch on any UK or foreign aircraft. Our experience of measuring seat pitch is that it may not always be a straightforward process, because as cabin furnishings wear following extensive use, dimensions can alter over time – seat backs may relax somewhat from the fully upright position, and seat cushions may elongate. We therefore suggest that a seat-pitch criterion should be chosen such that it clearly separates the majority of seats as being either well below or well above that criterion. Any formal determination would have to be made by measurement or possibly cabin layout drawings.

Responses to specific questions in the consultation paper

Option 1 – seat pitch only

17. We understand that under this option there would continue to be two APD rates relating to class of travel, but that seat-pitch would be the only criterion that determined which rate would be applicable.

Q1: Do you consider this an appropriate option?

Q2: Given the range of seat pitches available what do you consider to be an appropriate seat pitch with which to distinguish between an economy and premium product?

18. Answer Q1 and 2: Any choice of a dividing measurement would have to be based on cabin configurations used in current business models and would, therefore, potentially be arbitrary and would not take into account future product changes. For instance, a division based on a 40–50 inch seat-pitch range would probably move long-haul Premium Economy and short-haul Business Class into the lower rate band (British Airways, Virgin Atlantic and bmi, for example, currently offer a 38-inch seat pitch in their Premium Economy cabins, and short-haul Business Class would usually be less than this, and indeed may offer no more leg room than standard economy). This option would therefore meet the aim of re-aligning the APD rate for Premium Economy with that of Economy currently. It would also bring short-haul Business Class into the lower rate band. (Let us call this Option 1a.)

19. If the aim of Option 1 is not to bring long-haul Premium Economy and short-haul Business Class passengers into the lower rate band, but rather only to capture passengers on Business-Class-only flights in the higher rate band, then a narrower seat pitch threshold would be required. In our view this is unlikely to be successful. This is because of the wide range of airlines, short-haul/long-haul aircraft configurations and seat pitches falling in a relatively narrow range. This seems to be recognised by the consultation document. (There is also the potential for further complexity, for example where airlines are obliged to use substitute or wet-leased aircraft, the seat pitch of which they may not know at the time of booking.) What is more, there could even be a risk of a division at a narrower seat pitch skewing airline decisions on seat pitch. (Option 1b.)

20. If the aim of Option 1 is to bring long-haul Premium Economy passengers into the lower rate band, to capture passengers on Business-Class-only flights in the higher rate band, and to leave short-haul Business Class passengers in the higher rate band, then this implies that the criteria applying to short-haul flights would need to be different from those applying to long-haul flights. HMRC would need to consider whether applying different criteria is a reasonable option, given the relative product difference between Business Class and Economy Class on short-haul flights. For example, it could be argued that in the context of a two-class short-haul product, the current

positioning of the higher-rate threshold is less distorting of consumer choice than in the long-haul market. (Option 1c.)

21. We conclude that Options 1a and possibly 1c, where a robust seat-pitch criterion is set somewhere between typical Premium Economy and Business Class seat pitch, would be likely to meet the HMRC objectives of being transparent and simple to administer, subject to the necessary technical adjustments to reservation systems being feasible. However, Options 1a and 1c appear unlikely to be revenue-neutral without rebalancing APD rates, given that under both there are a far greater number of seats in Premium Economy (and short-haul Business Class under Option 1a) brought into the lower rate than seats on Business-Class-only flights brought into the higher rate.

Q3: What impact would this option have on ticketing/booking systems?

22. Answer Q3: The proposed divide between APD rates is based on a technical criterion unrelated directly to class of travel. This may be less straightforward where a ticket is sold for a multi-sector itinerary involving different classes of travel or where there is some doubt over the type or configuration of the aircraft at the time of booking³⁰. Seat configurations often vary even within a single aircraft type in a given airline's fleet.

Option 2 – fare codes and seat pitch

23. We understand that this option would use as its principal criterion how the product was marketed, using fare codes as the basis of the class of travel definition. This would be underpinned by a minimum seat pitch, so that the movement to a higher rate would be on the basis of a service meeting one or other of the criteria.

Q4: Would a combination of seat-pitch and fare codes be acceptable as the basis of class definition?

Q5: How would you incorporate this into your ticketing/booking system to allow you to identify correctly and for the APD due?

Q6: How would you show that the fare codes relate to the correct seat pitch on your flights?

Q7: For non-IATA members, how would you align your codes?

Q8: What impact would this have on through ticketing/interlining?

Q9: What impact would this have on interlining between flights operated by IATA and non-IATA members?

Q10: Would this option create any anomalies?

³⁰ According to the HMRC website, currently the higher APD rate is charged for a passenger travelling on a Heathrow–Madrid–Rio ticket without stopover where the passenger is seated in a higher class of travel on *either* of the two sectors. Therefore under Option 1 the reservation system would need to be appropriately programmed to handle the criterion based on seat pitch rather than class of travel on sectors not touching the UK.

Q11: What impact would this option have on ticketing/booking systems?

24. Answer Q4–Q11: It is true that for “traditional” IATA airlines, the class of travel can usually be determined by the generic reservation booking designators and fare classes that are attached to and identify a given fare type. The global distribution systems (GDSs) are already programmed to calculate automatically the appropriate taxes, fees and charges incurred for a particular itinerary where carriage is on airlines that participate in these systems. So this option would have the potential of allowing HMRC to differentiate more on the basis of fare type and/or class of travel than actual product differences. In theory it would mean, for example, that Premium Economy could attract a lower APD rate, while Business Class on short-haul flights could continue to attract a higher APD rate, if that were the desired result (see comments under Option 1).

25. The CAA is not expert in the programming of GDSs or the ability of systems to cope with this proposal. However, we are aware that the table of reservation booking designators shown in the consultation document is not comprehensive for all IATA airlines, let alone non-IATA airlines. There are many overlaps where a reservation booking designator means one class of travel for one airline and a different class for another airline, and such a table, if a definitive version were required, would have to be compiled for each airline individually.

26. It is possible that this could be made to work, but it may require a considerable degree of liaison between airlines (or representative bodies such as IATA) and HMRC. The terms “First Class”, “Business Class” and “Premium Economy Class” or the reservation booking designators normally associated with them do not necessarily indicate a comparable product, and airlines may deliberately avoid such labels for marketing or other reasons, all of which would need to be verified. This process would not just involve the larger IATA airlines, but also smaller airlines, airlines which serve the UK infrequently, and airlines which do not normally participate in GDSs like charter airlines and no-frills airlines. In each case the effort of ascertaining, and maintaining, details of seat pitch and/or fare code classifications could be considerable, and inconsistencies, omissions or confusion may arise. Any increase in administrative burden would however depend on the extent to which this process differs from that which exists already, and the extent to which HMRC needs to verify and enforce decisions by individual airlines as to which products and codes fall into which class of travel.

27. The CAA’s view therefore is that this option would be a possible way of achieving certain shifts between the APD bands, but it would depend on whether reservation systems can be programmed appropriately so that the correct APD rates are applied, and whether any additional administrative burden is imposed. If Option 2 is a means to move Premium Economy to the lower APD rate, then the same point on revenue-neutrality would apply as noted under Option 1 above.

Option 3 – seat pitch on single-class flights only

28. Our understanding is that this option would apply only where a single class of travel were offered. The lower rate would apply except where the average seat pitch exceeded a set amount. In all other cases the present system would continue to apply.

Q13: Do you consider this option would meet your concerns?

Q14: What do you consider to be the appropriate seat pitch with which to distinguish between a premium economy and business class product?

Q15: Would this option create any anomalies?

Q16: What impact would this option have on your systems?

29. Answer Q13–Q16: This option would mean that the higher APD rate was paid by passengers travelling in Premium Economy, Business, First or any other “premium” cabin, as at present, but, in addition, that passengers on Business-Class-only flights would also pay the higher rate. Because there is no change to the current system for the majority of passengers and airlines, this option would seem to give rise to the fewest anomalies while retaining the important transparency and simplicity for airlines, GDSs and consumers. It would also, we would imagine, give a revenue result that was predictable and with change kept to a minimum.

30. The seat pitch of current Business-Class-only airlines of at least 60 inches suggests that it should be possible to set the seat pitch threshold for the higher APD rate at a measurement that would unambiguously capture current and future Business-Class-only services.

31. Having said that, we understand that several UK operators specialising in short-haul “sole-use” charter services operate aircraft that can be configured with a single class, VIP premium product. The seat-pitch threshold chosen will determine whether VIP passengers on such charters pay the higher APD rate. However, the number of flights affected is likely to be relatively small. Similarly, it is conceivable that an airline may begin short-haul scheduled services where the whole cabin is configured and marketed as a premium product, with seat pitch falling somewhere between current short-haul flights and long-haul Business-Class-only flights. However, we are not aware of any plans for such a service or any trend in that direction.

32. This option would seem to target the perceived problem of Business-Class-only flights paying a lower APD rate than those travelling in Premium Economy and other premium classes, while offering a reasonable combination of clarity and broad revenue neutrality with the minimum regulatory burden placed on airlines. However, it would maintain Premium Economy in the current higher-rate APD band.

Option 4 – Do nothing

Q17: Are you in favour of changing the definitions of classes of travel?

33. Answer Q17: As we have made clear above, the CAA’s preference is that any market distortions caused by APD are minimised whether this be, for example, in the choice the passenger makes between airlines or between products offered by a given airline. The CAA recognises therefore that some changes to the APD system may be appropriate. However, the CAA also takes the view that the APD system should be kept as transparent and simple as possible, and should impose the minimum administrative burden on the industry. For that reason, any changes proposed should be a proportionate response to the perceived problem, and we suggest that HMRC should not discount the “do nothing” option if the alternative were to add significantly to the complexity or the administrative burden of the APD system.

Q18: If so, which of the options set out here do you prefer?

34. Answer Q18: In terms of minimum change, the CAA would favour Option 3, which deals with the most obvious market distortion of Business-Class-only flights, but does not alter APD for Premium Economy passengers. If HMRC sees a change to Premium Economy as desirable, a suitably robust seat-pitch criterion applied only to long-haul flights under Option 1c would seem to achieve this without necessarily knocking-on to short-haul flights. This option would also depend on the

ability of reservation systems to handle the changes on journeys involving connecting flights. Our main concern is that any solution along the lines of Option 1 (or 2) is as transparent as possible, practical and not overly burdensome on the industry, and that it does not give rise to further anomalies.

Q19: Is there an alternative that you would prefer?

35. Answer Q19: Beyond this, any changes to the APD system would probably need to be more fundamental, such as introducing more bands of charges, and relating those bands to fare levels rather than cabin class or on-board product, if HMRC's policy aims could not be met through the options considered here.

Civil Aviation Authority
July 2007

Cabin classes and fare overlaps

There is an increasing range of fares available in premium cabins, and premium products which differ significantly between airlines³¹ (as well as between short-haul and long-haul configured aircraft). The behaviour of passengers in their choice of cabin class continues to evolve. Some trends are driven by technological change and corporate cost efficiency initiatives. One effect is that the proportion of business passengers travelling in premium cabins has in recent years been in decline, in both long-haul and short-haul markets (Table 5-1). The decline in business passengers using short-haul premium cabins is particularly marked, having reduced from 41 percent in 1996 to just 5 percent in 2009 on international routes from London.

Table 5-1: Proportion of business passengers travelling in different cabin classes on international flights to/from London airports

Class of Travel	Business passengers as a proportion of passengers in each cabin			Proportion of business passengers using each cabin		
	1996	2007	2009	1996	2007	2009
North America						
First/Business	82%	77%	59%	38%	27%	16%
Premium Economy	n/a	57%	42%	n/a	14%	17%
Economy	27%	20%	17%	62%	59%	67%
Other Long-haul						
First/Business	74%	75%	58%	33%	24%	13%
Premium Economy	n/a	59%	29%	n/a	8%	8%
Economy	27%	18%	16%	67%	67%	79%
Short-haul						
Business	93%	81%	68%	41%	9%	5%
Economy	50%	27%	23%	59%	91%	95%

Source: CAA Passenger Survey, 1996, 2007 and 2009

(from *Flying on Business, a study of the UK business travel market*, CAA, December 2010)

Note: Only Heathrow, Gatwick, Stansted and Luton are included, as London City was not surveyed in these years.

³¹ See Table 6-7, *Flying on Business, a study of the UK business travel market*, CAA, December 2010.

Airline fare structures are now sufficiently broad and differentiated that a flexible fare in Economy may exceed a conditioned fare in Premium Economy, while a flexible fare in Premium Economy may exceed a conditioned fare in Business Class, depending on various factors such as the time of booking. As a result, cabin class is not necessarily a good indicator of relative fare levels, and the relative proportion that APD makes up of a fare can vary considerably. Anomalies therefore arise because APD is structured around cabin class rather than fare level (see the example of London–New York fares in Table 5-2 below).

Table 5-2: Virgin Atlantic London–New York fare structure (2010)

Cabin	Fare type	Round trip fare level 2010	Reservation class 2010
Upper Class	flexible (interlineable)	£6197	J
	flexible	£5560 & £5766	J
	Apex 1 (7D)	£4873 & £5079	D
	Apex 2 (14D)	£3890	D
	Apex 3 (30D later 28D) ☒	£3340 & £3546	D
	Apex 4 (28D) ☒	£2636 & £2749	R
	Apex 5 (42D later 28D) ☒	£1929 & £2157	Z
	Apex 5 (28D) ☒	£1498	Z
Premium Economy	flexible (interlineable)	£2999	W
	flexible	£1918 & £2068	W
	Apex 1 (7D) ☒	£1582	S
	Apex 2 (21D) ☒	£1242 to £1469	S
Economy	flexible	£1196	Y
	5 types/tiers of leisure fare ☒	£392 to £939	B,L,M,Q,X

Source: Airline Tariff Publishing Company, CAA records; adapted from *Flying On Business*, CAA, December 2010.

Notes: Fare structure applicable for travel as at July 2010. ☒ Saturday night minimum stay required
 Fares are published fares excluding inclusive tour, group, student fares etc. Weekend supplement not shown. Upper Class £1498 fare had limited selling and travel period.
 Fare levels include all taxes, fees and charges rounded to nearest £.
 Apex fares have a minimum advance purchase period which is shown in brackets.