Consumer Protection Group

Risk Analysis Department

Guidance on criteria for assessing the financial resources of new applicants and holders of operating licences

Version 10 (20 April 2010)

1 Introduction

1.1 **European Council Regulation (EEC) No 1008/08** on the licensing of air carriers ("the EEC Regulation") sets out the funding requirements for granting and maintaining an operating licence.

1.2 This guidance note outlines the approach that the CAA takes when considering an application for an operating licence as required by Article 5 of the EEC Regulation, and the ongoing requirements once a licence has been granted as set out in Article 8.

2 Financial tests

2.1 Article 5.1 of the EEC Regulation stipulates two financial tests that an applicant for an operating licence has to meet.

2.2 In accordance with **Article 5.1(a)**, an applicant needs to demonstrate that it can meet at any time its actual and potential obligations established under realistic assumptions, for a period of 24 months from the start of operations.

2.3 Article 5.1(a) is a liquidity test, which requires the CAA to ascertain whether the applicant has sufficient cash resources to support it during the first 24 months of operation.

2.4 In accordance with **Article 5.1(b)**, an applicant needs to demonstrate that it can meet its fixed and operational costs incurred by operations according to its business plan and established under realistic assumptions, for a period of three months from the start of operations, without taking into account any income from its operations.

2.5 Article 5.1(b) is a test that aims to set a funding level that is in direct proportion to the scale of the planned operations.

2.6 The CAA will set the funding requirement at the higher amount reflected in the assessment of the two tests.

3 Information required

3.1 In order to determine whether an applicant meets the two financial tests, the CAA will carry out a detailed assessment of the applicant's business plan, financial forecasts and underlying assumptions. This is discussed in detail in sections 6 and 7 below.

3.2 Full details of the information that should be included in the business plan are detailed at Appendix A and summarised as follows:

- Details of the applicant's source of funding and proposed shareholder structure, including the nationality of the shareholders;
- Details of the applicant's organisational structure and a description of management and its experience in establishing and operating an airline;

- An analysis of the strengths, weaknesses, opportunities and threats of the proposed business;
- An outline of the proposed services, including fleet strategy;
- A market analysis of the proposed routes, including competition, as well as current and forecast demand;
- Key strategy in respect of marketing, pricing and distribution;
- An assessment of the key business and financial risks and how the applicant intends to mitigate them;
- Detailed financial projections for the first three years comprising monthly profit & loss, cash flow and balance sheets together with supporting assumptions. The projections should be provided in an Excel spreadsheet format.

4 Financial assessment procedure

4.1 The table below outlines the steps that the CAA will typically follow when considering an application under Articles 5.1 (a) and (b):

Steps	**Commentary**
Submission of application and business plan	The CAA will respond in writing within 14 days and set out what additional information it will require to commence the assessment.
Applicant's management to present business plan	At the beginning of the process, management will be given an opportunity to present its business plan and elaborate on the forecasts.
Analysis of the business plan and financial projections	The CAA will review the viability of the plan and consider whether the assumptions are achievable using CAA and market data.
Adjustment to the financial projections	Following the analysis of the financial projections, the CAA may make adjustments to the assumptions used which could result in a different funding requirement to that assumed in the business plan. The CAA will also carry out stress testing in order to assess whether the applicant's financial resources are sufficient to survive adverse market conditions. This will be reflected in the final funding requirement.
Communication with the applicant	The CAA will communicate its key findings to the applicant throughout the process. Further meetings may be required to discuss the CAA's analysis.
Decision on application	Following the analysis, the CAA will inform the applicant in a decision letter of the funding required to meet the two tests under Article 5. The decision letter may also include additional conditions on which a licence will be granted

	(e.g., the AOC).

4.2 If the operating licence has not been granted three months after the decision letter has been issued, the application will have to be re-assessed to consider whether the original funding decision remains valid. This may involve an additional fee, depending on the level of additional analysis that the CAA has to undertake of any revised business plan.

5 Timescales

5.1 The CAA is obliged under its Code of Conduct, to produce a decision not more than two months after receiving all of the required information. It is important to remember that the two–month period does not start until the CAA has received all of the information it requires.

5.2 In the CAA's experience it is rare for an applicant's plan, and even its first response, to include enough information for the CAA to reach a decision. It would therefore be prudent for the applicant to allow more than two months for this process to be completed.

6 The CAA's approach to considering Article 5.1(a) - The 24-month test

6.1 This section discusses the approach that the CAA adopts in assessing an applicant's business plan and financial forecasts for the purposes of Article 5.1(a).

6.2 The analysis of the business plan will focus in particular on:

- The experience of the applicant's management team in establishing a new business and operating an airline;
- The condition of the markets targeted by the applicant, particularly in regard to existing and potential competition;
- The attractiveness to the market of the product that the applicant is offering;
- The effectiveness of the proposed operation;
- Its marketing and distribution strategy; and
- Its risk management systems.

6.3 The analysis of the financial forecasts will principally focus on the validity of the following key assumptions:

- Revenue (passengers, yields and other revenue);
- Cost (direct operating costs, fixed costs and overheads);

- Foreign exchange and interest rates;
- Working capital (debtor and creditor payments);
- Capital expenditure and financing costs.

6.4 In analysing the financial projections the CAA will:

- Benchmark revenue, cost, capital expenditure and financing assumptions against internal and external data;
- Take into account historic growth trends, and potential stimulation effects by introducing additional capacity;
- Undertake a statistical analysis using the Competitive Performance Indicator ("CPI") based on CAA Airport statistical data and CAA Origin and Destination survey data;
- Utilise external market reports;
- Review key contracts, including bank facilities, aircraft financing agreements and merchant acquirers' terms;
- Allow for learning curve effects in the first two years of operation.

6.5 Based on the outcome of its analysis, the CAA may have to adjust the applicant's original assumptions in the financial projections. This may lead to an additional funding requirement in order to meet the test under Article 5.1 (a).

7 CAA's approach to Article 5.1(b) – The three-month test

7.1 This section discusses the approach that the CAA adopts in assessing whether the proposed funding is adequate to meet the test under Article 5.1(b).

7.2 This test aims to set a funding level that is in direct proportion to the scale of the planned operation.

7.3 In considering this test, the CAA needs to ascertain whether the applicant has sufficient resources available at the commencement of operations. In considering this, the CAA will assess the balance sheet position at the commencement of operations and calculate the level of liquid assets that are available, or assets that can be readily converted into cash (i.e. assets that could support borrowing). Details of assets that the CAA would allow or exclude in the calculation can be found at Appendix B.

7.4 In order to meet the requirements of Article 5.1(b), the applicant must have financial resources that are greater than its first three months of future operating costs. This includes direct and fixed operating costs and overheads.

7.5 The CAA will use the same cost assumptions established in the 24-month test.

8 Form of funding

8.1 The CAA would normally require that a start up airline meets its funding requirements with equity.

8.2 In limited circumstances the CAA may allow partial debt funding. However, the debt would have to be fully subordinated to all other creditors in accordance with the CAA's standard form of words.

9 Type B operating licence applications

9.1 An applicant that intends to use aircraft with less than 20 seats and/or weighing less than 10 tonnes does not have to meet the funding requirements of Article 5. In this case, the CAA has the discretion to apply the two financial tests if it deems the operation is of a significant size (i.e. an applicant planning to operate a large fleet of small aircraft or a substantial route network) whereby there could be significant consumer protection issues in the event of a financial failure.

10 Quasi-airlines

10.1 An applicant wishing to start an airline may initially apply for an ATOL, with the intention that the operation of the aircraft will be conducted by an existing operating licence holder under a management contract. The CAA refers to such operations as quasi-airlines. Generally speaking, applicants use this approach as a short term measure with the intention to apply for an operating licence at a later date.

10.2 In considering the financial aspects of the ATOL application, the CAA will consider such a proposal on the basis that the costs and risks faced by the venture are the same as those of an airline rather than a tour operator and will therefore apply Articles 5.1 (a) and (b).

10.3 There are a number of potential disadvantages in using the ATOL route to establish an airline:

- According to the CAA's ATOL Policy 2010/08, new applicants are required to provide a bond for the first four years. The bond is based on 15% of forecast annual turnover;

- As an ATOL holder, the applicant will also have to make contributions to the Air Travel Trust Fund via the ATOL Protection Contribution (APC);

- ATOLs can only be granted for periods of up to 12 months at a time. On renewal of the licence, the applicant has to meet a free asset test under the ATOL Regulations (Link to ATOL free asset test). In contrast to the ATOL, the operating licence is not subject to an annual renewal process;

- If the applicant later decides to apply for an operating licence, it will then be treated as a new applicant and will have to meet the two financial tests under Article 5 of the EEC Regulation.

11 Integrated Groups

11.1 ATOL holders who wish to establish an in-house airline and apply for an operating licence will have to consider the following:

- The application will be assessed under Articles 5.1(a) and (b);

11.2 At the annual renewal of the ATOL, the financial assessment will be carried out on a consolidated basis (i.e. including the airline);

12 Financial information required from holders of operating licences

12.1 In order to consider whether it can remain satisfied with the financial resources of a licence holder, pursuant to Article 8 of the Regulation, the CAA will require the following information to be provided:

- Annual budgets, comprising of profit & loss forecasts, cash flow forecasts and balance sheets;
- Key assumption drivers behind the budget;
- Monthly management accounts, incorporating the same information provided in the budget;
- Annual audited accounts.

12.2 The CAA may also need to request some additional financial information depending on the circumstances of the licence holder.

12.3 Whilst the CAA is required to assess the finances of an applicant that is intending to operate a pure cargo/freight operation with aircraft that are greater than 10 tonnes maximum take off weight, it does have discretion whether or not to continue monitoring the applicant after the licence has been granted.

13 Expansion plans

13.1 As required by Article 8.5, a licence holder should notify the CAA in advance of any planned changes in the nature of operations. This includes:

- The operation of a new air service to a continent or a world region not previously served;
- Changes to the aircraft type used (wide-body vs. narrow-body);

- Changes in the size of the fleet operated;
- General expansion of operations, either organic or through acquisition (>10% is material); and
- An intended merger or acquisition

13.2 If the CAA considers that the changes notified have a significant bearing on the finances of the company, pursuant to Article 8.6 of the Regulation, the CAA will require a new 12-month business plan to be submitted, incorporating the changes in question. The information that should be provided will include the following:

- Precise details of all the proposed changes e.g. new routes proposed, additional aircraft to be acquired either purchased or leased;
- Profit & loss forecasts, cash flow forecasts and balance sheet forecasts on a monthly basis;
- Full supporting assumptions for key drivers for revenue and costs in the forecasts;
- Details of the source and structure of any new financing to be provided to support the proposed expansion;
- Details of the financing arrangements for additional aircraft;
- The most recent management accounts.

13.3 Article 8.6 of the EEC Regulation then requires that the CAA should decide whether it is satisfied that the licence holder can meet its existing and potential obligations during the next 12 months. The CAA is required by Article 8.6 to make a decision no later than three months after all the necessary information has been submitted. The CAA will however endeavour to reach a decision within two months as set out in its “Code of Practice”.

Appendix A –Suggested format for the business plan

Annex1 to the EECI Regulation sets out the financial information that should be provided pursuant to Articles 5 and 8, which includes provision of a detailed business plan. In order to fully evaluate the proposal, the CAA would expect the business plan to include the following:

a) Executive Summary

- Objectives;
- Mission;
- Keys to Success.

b) Company Summary

- Company Ownership - including details of the source of finance and proposed shareholders, itheir nationality and full details of shares held. Useful supporting documentation would include any shareholders' agreements and the Articles of Association;
- Start-up summary – comprising details of costs and how these will be funded;
- Head office location and facilities.

c) SWOT Analysis

- Strengths;
- Weaknesses;
- Opportunities;
- Threats.

d) Services

- Description of the proposed services to be operated – including proposed routes and timetables;
- Details of type of service to be provided – i.e. leisure, business or a mix of both;
- Pricing strategy – details of fare structure;
- Technology available – i.e. Development of in-house yield management or reservations systems or purchase of existing technology;
- Aircraft – reasons for proposed aircraft selection and whether operating leases or purchases are considered. Drafts of any proposed agreements should be provided;
- Third party contracts - Copies of any proposed contracts should be provided. This could be for aircraft maintenance, fuel, foreign exchange, interest rates or arrangements with the merchant acquirer for handling credit card receipts;

e) Market Analysis

- A report on current market environment;
- Details of competitors on each route;
- Basis of demand assumptions used in financial forecasts;

- Any independent market research studies;

f) **Strategy and Implementation**

- Marketing strategy;
- Pricing Strategy;
- Promotion Strategy;
- Sales Strategy;
- Milestones.

g) Management Summary

- Organisation Structure;
- Management Team - including CVs;
- Personnel Plan.

h) Business and Financial Risk assessment

- The CAA will need to be satisfied that the applicant has adequate systems in place to monitor such risks and sufficient policies in place to mitigate the impacts of such risks. Key risks to be considered should include the following:

Business risks	Financial risks
Competition	Fuel
Loss of market share	Foreign exchange
Distribution strategy	Cash flow generation
Product strategy	Profitability
Problems in region operated	Facilities
	Balance sheet

i) Financial forecasts

The financial forecasts should incorporate the following:

- Detailed forecasts for a three year period comprising profit & loss account, cash flow forecast and balance sheets on a monthly basis. The forecasts should be broken down on a route basis and include an overall consolidation of the total operation;

- The forecasts should detail individual route contribution statements which include as a minimum the Key Performance Indicators – sectors, block hours, capacity, load factors, yields (gross & net) and passengers, full breakdown of

DOCs (by route)/FOCs and Overheads (consolidated). This statement should also split out any cargo, charter and ancillary revenue;

- Full details of the assumptions used in respect of revenue and costs (on an hourly, sector or passenger basis as applicable) should be provided. If discounts are to be provided against published costs at airports, written confirmation will be required from the relevant airport;

- Where the applicant is part of a group, the CAA will require the above forecast information to be provided on a consolidated basis which separately splits out the various trading divisions of the group;

- For an applicant that has been trading for some time already, the most recent set of audited accounts and recent management accounts. If the applicant is part of a group, audited accounts for the parent company;

- Details of any financing agreements in which the applicant is or expects to be involved, such as overdraft or bonding facilities. Supporting documentation would include drafts of the relevant agreements.

Appendix B – CAA assessment of an applicant's financial resources

This Appendix outlines how the CAA assesses the balance sheet to ascertain whether an applicant has sufficient resources available at the commencement of operations as required by Article 5.1(b) of the EEC Regulation.

The CAA will assess the balance sheet position at the commencement of operations and calculate the level of liquid assets that are available, or assets that can be readily converted into cash (i.e. assets that could support borrowing).

The CAA will therefore deduct particular categories of asset from the net assets. The following outlines the most common balance sheet items and how they are normally treated in the CAA's calculation:

Fixed assets

Freehold land and buildings	75% of the Net Book Value (NBV) is given for freehold land and buildings in the EU, Switzerland, USA, Canada, Australia or New Zealand. The CAA may consider a professional valuation carried out since the balance sheet date rather than using the NBV in its calculation, in which case, 75% of the valuation is included. The CAA expects the valuation to be reflected in the following year's financial statements. Where the CAA relies on a professional valuation, it should be no more than three years old. In exceptional circumstances, properties in locations other than those mentioned above may also be considered.
Leasehold property	75% of the NBV is given for long leasehold property with at least 20 years remaining on the lease. Property with less than 20 years of the lease remaining is deducted.
Fleets of aircraft, ships, spares and stocks of fuel	75% of the NBV is given to fleets of aircraft and ships. 75% of the NBV is given to spares for aircraft and ships and rotable stocks.
Assets under construction	75% value is given to aircraft under construction.

Improvements to assets under operating leases	No value is given to improvements such as specific improvements or fixtures fitted to such assets.
Plant & equipment	50% value is given for heavy maintenance equipment. Other minor equipment is deducted.
Other fixed assets	No value is allowed for other fixed assets. This includes cars, office equipment, fixtures and fittings and computers.
Listed shares	The CAA takes into consideration investments in publicly quoted companies in circumstances where the investment can be realised at all times. However, because share values can change quite considerably, the value allowed in the free asset calculation is 50% of the balance sheet value.
Unlisted investments	Unlisted investments are deducted.
Bonds	100% value is given to the lower of the book value or market value of government bonds of EU countries, Switzerland, USA, Canada, Australia and New Zealand and bonds issued by institutions guaranteed by the UK Government. 70% value is given to the lower of the book value or market value of bonds with an investment grade rating. 50% value is given to the lower of the book value or market value of other investment bonds.

Intangible assets

Intangible assets	Intangible assets are deducted.

Current assets

Prepayments	Prepayments relating to the following are deducted: Brochure costs; Advertising and other publicity costs; Any amounts where the CAA has not been provided with a detailed breakdown or where, in the opinion of the CAA, an amount is not readily recoverable.
Other debtors	The following items are deducted: Short-term loans to directors; Any amounts where the CAA has not been provided with a detailed breakdown or where, in the opinion of the CAA, an amount is not readily recoverable.
Restricted assets	The value of cash or any other assets that are blocked or otherwise restricted is deducted.
Consumable Stocks	The value of stocks is deducted.
Deferred tax assets	Deferred tax assets are deducted.
Inter-company debts	The CAA looks closely at any amounts in the balance sheet that are due to an applicant from related parties, whether short or long-term. This includes amounts due from businesses that are linked to an applicant through common directors, owners or shareholders, or those with which an applicant has close trading links. Where, in the opinion of the CAA, an amount due to an applicant is not considered to be payable under normal commercial terms or is not considered capable of being repaid in the current financial year, it is deducted.
Derivatives	The value of derivatives is deducted.

Liabilities

Long-term loans	All long-term debt is treated as a liability unless it is formally subordinated and a Deed of Subordination (in the CAA's format) has been provided to the CAA.
Pension liabilities	Pension liabilities disclosed in the financial statements are deducted.
Deferred tax liabilities	The value of deferred tax liabilities is deducted.
Preference shares	The CAA views redeemable preference shares in the same way as it views debt. The value disclosed in the balance sheet is deducted unless the CAA receives an undertaking (in the CAA's format) that the shares will not be redeemed.
Provisions	Provisions disclosed in financial statements are deducted.

Other secured assets

Bonds, letters of credit and guarantees	The value of bonding (e.g. IATA, ATOL or ABTA bonds) or other guarantees to third parties and letters of credit are deducted if they are secured on an applicants assets.