

Promoting Financial Resilience for Major Airports: Analysis of Consultation Responses and Government's Decision

Executive Summary

Following consultation, this Government has set out its intention to introduce a package of measures for major airports designed to promote the interests of passengers. In this context, the Government intends to drive investment and assist continuity of service in the event an operator gets into financial difficulties. These reforms are applicable to airports with substantial market power and consist of:

- A general obligation on the licensee to prepare a Continuity of Service Plan (CSP) and to keep the plan in a serviceable state.
- A requirement on the regulator (The Civil Aviation Authority) to apply agreed tests when considering the removal of an airport's derogations and an appeals process that is aligned with the wider licence modification process.

The decisions outlined in this document are part of a wider package of proposed reforms¹. The Government has announced its intention to introduce as part of this package reforms to promote financial resilience which include:

- A financing duty to ensure that licence holders are able to finance their activities which would sit as a subordinate duty to the regulators primary duty to promote the interests of passengers. This duty should be interpreted to apply to an efficient operator, not for example as an obligation to bail out an operator in financial difficulty.
- A minimum credit worthiness requirement for licensed airports.
- Ring fencing provisions similar to those in place in other regulated sectors with initial derogations from some of those provisions where the costs of introducing those provisions would exceed their benefits.

This document sets out the decisions taken by the Government following the consultation published late last year on the tests to the ring fence, its appeal process and a Continuity of Service Plan.

Introduction

In December last year, the previous Government published a consultation entitled Promoting Financial Resilience for Major Airports, alongside its decision document on the wider reforms to the economic regulation regime.

¹ Reforming the Framework for the Economic Regulation of Airports: Decision Document, December 2009.

The consultation essentially made two proposals to:

1. Introduce a requirement to produce and maintain a Continuity of Service Plan (CSP) as a condition in the new licence.

Having concluded that the benefits of Special Administration regime were not sufficient to support its introduction because they do not outweigh the costs, the Government decided not to proceed with that proposal. In light of that, the previous Government proposed the introduction of a Continuity of Service Plan. The policy intent was to protect passengers in the event of an insolvency, by seeking to ensure the continued operations of an airport with a Tier 1 licence. The plan would provide information about the key processes, services and other measures required to keep an insolvent airport operating thus minimising disruption to the business from an insolvency process.

2. Place a requirement on the regulator to meet “switching on” tests for ring fencing licence conditions and allow for that decision to be appealed by the licensee, Passenger Focus and the Secretary of State.

A ring fence consists of a number of provisions that, amongst other things, are designed to ensure that the regulated company has full access to the necessary resources to fulfil its licence commitments and that the assets ultimately paid for by passengers are available for use by them. It remains this Government’s view that the introduction of some of those provisions could result in costs that exceed their benefits, and therefore those provisions should appear in the licence but be temporarily “switched off”. The intention remains that there will be a move to a full ring fence as soon as circumstances permit. The policy intent for the proposals is to give investors and industry some additional certainty as to the circumstances whereby individual provisions for the ring fence could be switched on.

This Government has reviewed the proposals and believes that for the majority of them the rationale remains valid. This document explains the conclusions reached and their justification. A list of respondents to the consultation can be found in Annex B.

Introduction of a Continuity of Service Plan as a Licence Condition

Proposal

The consultation document proposed the introduction of a CSP as a condition in the Tier 1 licence because of the low probability but high impact risk of Tier 1 airport closure. A CSP is intended to minimise disruption to the business from the insolvency process, thus increasing the likelihood of operational continuity.

The following questions were asked:

- Should the regulatory regime include a licence condition in Tier 1 licences to produce and maintain a CSP in the initial licence and allow the regulator to introduce such a licence condition in future licences?
- If such a licence condition were to be introduced, what would be the costs and benefits of such a step?
- If such a licence condition were to be introduced, is there any information in the list set out in the consultation document that is not required, and why is it not required? Is there any additional information that should be included in a CSP, and if so why?
- If such a licence condition were to be introduced, how often or on what basis would the plan need to be updated in order for it to remain relevant?

Summary of consultation responses

Respondents to the consultation were, on the whole, supportive of the proposal to introduce a requirement to produce and maintain a CSP. The majority of consultees were of the opinion that the costs of such a condition would not outweigh the benefits although there were varying views as to how often the plan should be updated and what it should include.

Consultees identified administrative costs falling on both the licensee and the regulator. Some consultees stated that the burden on licensees would arise from collating and maintaining the information required for the plan. The extent of the costs would depend on the frequency of reviewing the content of the plan and what the plan would cover. However, it was also suggested that the licensee could recover most of the costs from the plan through the price control. The regulator identified one off and ongoing costs falling on the regulator for implementing and maintaining the CSP and these have been published.

Some consultees felt that the CSP was unnecessary because; it duplicated an Emergency Response Plan or conditions existing in financing arrangements; experienced insolvency practitioners were unlikely to find it useful; other regulated sectors were not required to maintain a CSP; and the plan would be meaningless as it would be unable to capture the complex ownership structure of many airport groups. One respondent felt that the CSP provided an inadequate alternative to Special Administration.

However, the majority of consultees were in favour of the plan and cited its benefits as:

- increasing the credibility that airports would be allowed to enter administration thus sharpening the incentives of operators and providers of finance to adopt appropriate financial structures;
- potentially decreasing the costs incurred during a period of administration;
- allowing the regulator to potentially identify arrangements that might increase the likelihood of service discontinuity in advance and take appropriate regulatory action through additional licence conditions;

- facilitating faster transfer of management from the insolvent operator to the insolvency practitioner; and
- mitigating the risks to airlines of committing as partners to the substantial investments which occur at Tier 1 airports.

Views on how often the plan should be updated ranged from daily to every five years or in line with the price review. There were also differing opinions from consultees on what the plan should include, with dispute focussed on the necessity of including information relating to capital expenditure, cash flows and project funding. Several consultees suggested that both the frequency of review and the contents list should be decided by the regulator with regard to the individual situation of the airport under consideration.

Some consultees who supported the introduction of the CSP stated that it should only apply to Heathrow and that the plan would only work if the licence prohibits the airport from ceasing to operate.

Government's decision

Following careful consideration, the Government has concluded that there should be a general obligation on Tier 1 airports in their licence to prepare a CSP and to keep the plan in a serviceable state.

We agree that the CSP could bring the benefits cited in the responses above. In particular that it would sharpen incentives on operators and other providers of finance to adopt appropriate financial structures by increasing the credibility that airports would be allowed to enter administration, and that the plan would also allow the regulator to identify risks to service continuity which it could then regulate through further licence conditions².

The Government does not support the view that there is no reason for the airport sector to have a CSP because it is not a requirement in other regulated regimes. We intend to introduce a CSP in the light of our decision not to bring in Special Administration – a regime which most other regulated sectors have in place. However, this Government believes that the introduction of a Special Administration regime would result in costs that exceed the benefits and therefore should not be introduced. We believe that a CSP would protect passengers by providing a proportionate response to the low probability risk of a major airport discontinuing its services.

Our intention for the CSP is to provide ease of access for the insolvency practitioner and for it to bring together information identified as key to the continued operation of the airport. Having taken advice from appropriate experts we believe that insolvency practitioners are likely to find the CSP useful. We would expect the initial CSP to cover, but not be confined to, the

² In order to add further licence conditions the regulator would need to follow a licence modification process that requires that those with standing rights to appeal do not object to the proposal, or (if they do) a reference to the Competition Commission .

list suggested in the consultation document where the regulator (or Secretary of State for the initial licences) thinks it is appropriate and where it has been agreed with the licensee. If there was disagreement on the content of the CSP, the licence modification procedure allows for the right to object.

Following consideration about the costs relating to the frequency and the basis on which the plan would need to be updated, we expect the CSP to be updated on a regular basis. We also expect the CSP to be updated as circumstances change. This means that whenever there is a change to the facts and matters which could result in aspects of the plan being out of date then the operator should be obliged to update the plan.

We do not believe that the CSP should apply only to Heathrow because all Tier 1 airports will lack alternatives for passengers and therefore require licence conditions to protect passengers in the event of insolvency. However, we expect the CAA to tailor the CSP to the individual airports circumstances where it is in the passengers' interests.

This Government has considered whether a condition in the licence should prohibit the airport from ceasing to operate in the event of insolvency. However, we believe that this would not be an effective means of ensuring or facilitating the continued operation of an airport in such circumstances. Furthermore, the cash generative nature of the airport business makes the probability of airport closure in such circumstances low.

To summarise, the Government believes there should be a general obligation on the licensee to prepare a CSP and to keep the plan in a serviceable state.

Requirement for the regulator to meet switching on conditions for a ring fence

The Government intends to introduce a package of licence conditions to introduce financial ring fencing which, amongst other things, intended to ensure that licensed assets ultimately being paid for by the passenger are available for use by the passenger. However, we have also decided that the costs of introducing certain elements of the ring fence would exceed the benefits and therefore there would be derogations for those elements of the ring fence.

Proposal

The consultation proposed that the regulator would only be able to initiate the standard licence modification process to remove derogations from the ring-fence after determining that the following tests had been satisfied:

- i) A material change of circumstances; and
- ii) The benefits of the proposed modification exceed the costs.

It was proposed that any decision by the regulator on whether or not the tests have been satisfied could be appealed by the licensee, Passenger Focus and

the Secretary of State. The appeal was proposed to be on an adjudicative basis to the Competition Commission.

The tests would be applicable to the removal of the initial derogations only. The strategic objective would be to move to a full ring fence over time, however, the purpose of this proposal was to offer additional certainty as to the circumstances in which the regulator is able to remove or seek to remove existing derogations.

The following questions were asked:

- Do you agree that for the removal of initial derogations there should be a supplementary test for the regulator to consider?
- Do you agree that the proposed supplementary test consisting of a material change in circumstance and cost benefit analysis would achieve the DfT's objective outlined in paragraph 9?
- If you disagree what alternative would you suggest that meets the DfT's objective, and why?
- Do you agree that appeals of a decision by the regulator as to whether the conditions for removal of the initial derogations have been satisfied should be to the Competition Commission on an adjudicative basis and that the parties who should be able to appeal are the regulated company, Passenger Focus and the Secretary of State?

Consultation responses

The majority of responses were in favour of the two tests. However, a number of consultees felt that the two tests would add unnecessary complexity, cost, confusion, and time to the process for removing the initial derogations and that it could potentially undermine the statutory duties. One consultee stated there was no reason to justify special treatment of the ring fence when more important regulatory decisions do not have additional conditions attached. Further concerns were raised about 'greater' regulation for companies with 'better' finances and whether this was consistent with the principles of Better Regulation. One consultee provided indicative costs to the regulator from implementing the supplementary tests.

One consultee argued that that the derogations should be permanent. Another consultee proposed that a more robust approach in addition to supplementary tests would be setting the initial derogations for a minimum period consistent with the term of the financing arrangements in place (possibly in conjunction with a requirement that the licensee maintains a certain level of creditworthiness).

One consultee expressed concerns about whether the additional tests are desirable or workable. They were concerned that the tests would act against a clear understanding that the responsibility for, and consequences of, airports' financial structures rest entirely with their owners. They also felt that the tests would not provide any additional clarity about when a full ring-fence might be 'switched on' and acts against the objective to move towards a full

ring fence. This consultee stated that if a separate mechanism was necessary, then the lifting of derogations should be tested against the statutory duties and attract an adjudicative appeal to the CC. If the regulator considered it appropriate to amend the licence conditions included in the initial licences, this should be dealt with through a normal licence modification, attracting a potential investigative appeal to the CC

Several consultees argued that, should the tests be introduced, the proposed appeals process was unnecessarily complex and unwieldy, because it involves two - potentially simultaneous - processes, both involving the CC, but against different tests and different standards of proof.

There were several objections to giving a right of appeal to Passenger Focus while denying a right to airlines, on the basis that Passenger Focus would not have sufficient resources, or expertise to appeal in order to protect air passengers' interests. It was suggested that airlines should have a right of appeal, either instead of, or in addition to, Passenger Focus because airlines have a commercial imperative to act in order to protect passengers.

While agreeing with the proposed conditions, several consultees thought more detail was necessary, on both what constitutes a material change of circumstance and the cost benefit framework that would be used.

However, as stated, the majority were in favour of the two tests. Several consultees' agreed with the proposals for the supplementary test as set out in the consultation document, concurring with the view that the alternatives set out were not workable and that the tests proposed were appropriate. One consultee stated that the supplementary test has the potential to be an effective and proportionate mechanism for creating additional certainty.

Another consultee stated that providing clarity on the mechanism to switch off initial derogations for financing arrangements is important for creditor analysis, while another argued that additional certainty will generate significant benefit for passengers by lowering the costs of financing for airport investment, compared with a situation where there were no such supplementary test.

Government's decision

Following careful consideration, this Government is of the view that the benefits of having two tests to apply before the regulator should be empowered to propose the removal of the initial derogations would exceed the costs. The Government's objective is to provide some additional certainty as to the circumstances in which the regulator is able to remove, or seek to remove, the initial derogations due to the impact such a removal could have on investment. On the whole, consultees did not present any alternative proposal that would achieve this objective. We believe that the very presence of the derogations indicates that the licence conditions relating to financial ring fencing require some transitional arrangements. These arrangements are

intended to allow for a transition to a full ring fence as soon as circumstances permit.

We are not of the view that the supplementary tests would undermine the proposed statutory duties. The tests are consistent with the CAA's new primary duty. It would be for the CAA to decide whether removing the initial derogations in any particular case would be consistent with its statutory duties.

We are also not of the view that the proposal would apply 'greater' regulation to an airport with 'better' financing and thus effectively create an uneven playing field within the sector. We believe that the proposal would allow targeted regulation because the regulator would have the flexibility to regulate each airport as it deems necessary and appropriate in order to meet its new primary duty to further the interests of passengers.

If the derogations were permanent it could result in their remaining even in circumstances where it would be in passengers' interests to remove them. Accordingly, we do not think it would be appropriate for derogations to be permanent as suggested by one consultee. The Government's objective remains to move to a full ring fence when circumstances permit.

We are also not persuaded that setting derogations for minimum period is appropriate. We were not provided with any evidence or other reason to contradict the view as presented in the consultation document that time based derogations may lead to the imposition of elements of the ring fence where the costs of introducing those elements outweigh the benefits. However, the precise terms of derogations will be subject to consultation.

Given that no feasible alternatives were proposed which achieve the stated objective, the Government believes that the additional tests to be met by the regulator should be a material change of circumstance and that the benefits of any proposed modification exceed the costs to them. We would expect the regulator to determine what constitutes a material change of circumstance and to carry out the cost benefit analysis in a manner that is consistent with its statutory duties. We also believe that it would be inappropriate for Government to produce further guidance on what constitutes a material change of circumstance or the cost / benefit analysis framework because this is a matter for the independent regulator.

Following evidence from consultees, the Secretary of State has also decided not to have an additional adjudicative appeal process for the two tests. Removing the derogations is one decision with three linked components (the two tests and the subsequent licence modification proposal). Accordingly, appeals on these components should be considered together rather than separately as previously proposed.

The Government is of the view that rights to object should be consistent with the rights to object for the licence modification process. We see no evidence to suggest that a different approach should be taken in relation to proposed

licence modification to remove ring fence derogations. However, the CAA may determine either that the additional tests have not been met or (if they have) that, notwithstanding, there should not be a licence modification proposed to remove the derogation. In these circumstances, we think those with rights to object should be empowered to require the CAA to refer that decision to the Competition Commission for a determination.

To summarise, the Government's decision is that the regulator shall only be empowered to propose a modification to switch on the ring fencing licence provisions for which the Secretary of State has granted a derogation after determination that two tests have been satisfied, those tests being that:

- a) Material change of circumstances; and
- b) The benefits of the proposed modification exceed the costs.

Those two tests should be considered within the context of the CAA's statutory duties. The regulator would then be empowered to proceed with the standard licence modification process to remove the initial derogations.

The Government intends that any decision by the CAA to switch on a ring fencing provision where derogation has been granted in the initial licence would be subject to objection on the same basis as the licence modification process. Where there has not been a licence modification, those with rights to object should require the CAA to refer the decision to the Competition Commission.

Annex 1: Questions for Stakeholders from the Consultation Document

Introduction of a Continuity of Service Plan

- Should the regulatory regime include a licence condition to produce and maintain a CSP in the initial licence and allow the regulator to introduce such a licence condition in future licences?
- If such a licence condition were to be introduced, what would be the costs and benefits of such a step?
- If such a licence condition were to be introduced, is there any information in the list above that is not required, and why is it not required? Is there any additional information that should be included in a Continuity of Service Plan, and if so why?
- If such a licence condition were to be introduced, how often or on what basis would the plan need to be updated in order for it to remain relevant?

Ring fencing Switching on Mechanism

- Do you agree that for the removal of initial derogations there should be a supplementary test for the regulator to consider?
- Do you agree that the proposed supplementary test consisting of a material change in circumstance and cost benefit analysis would achieve the Government's objective outlined in paragraph 9 of the consultation document?
- If you disagree what alternative would you suggest that meets the Government's objective, and why?
- Do you agree that appeals of a decision by the regulator as to whether the conditions for removal of the initial derogations have been satisfied should be to the Competition Commission on an adjudicative basis and that the parties who should be able to appeal are the regulated company, Passenger Focus and the Secretary of State?

Annex 2: List of Respondents

	Respondent
1	Aberdeen Airport Consultative Committee
2	Airport Transport Users Council
3	Airline Operators Committee
4	Association of British Insurers
5	BAA
6	Board of Airline Representatives in the UK
7	British Airways
8	British Business & General Aviation Association
9	easyJet
10	Gatwick Airport Limited
11	Gatwick Airport Consultative Committee
12	Global Infrastructure Partners
13	International Air Transport Association
14	Manchester Airports Group
15	Royal Bank of Scotland
16	Stansted Airlines Consultative Committee
17	Stop Stansted Expansion
18	The Civil Aviation Authority
19	Thomson Airways
20	Unite the Union
21	Virgin Atlantic Airways
22	Which?