

Consumer Protection Group



CAP 751

**Financial Protection for Air Travellers and
Package Holidaymakers in the Future**

CAA Advice to Government, July 2004



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Annex: Summary of principal changes made to the draft advice published in March 2004

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1 Introduction

- 1.1 This paper sets out the CAA's advice to Government on the protection for flights and holidays that it regards as appropriate for the future, and on the legislative changes that the CAA regards as necessary for that protection to be provided.
- 1.2 The CAA's conclusions have been reached following a detailed process of consultation and research. It first published a consultation paper in July 2003 setting out the issues and pointing generally to a need for changes in legislation: it sought views on what those changes should be. In March 2004, the CAA published in draft the advice that it proposed to give to Government and has subsequently amended that draft advice in the light of the comments it received and after further consideration.
- 1.3 The high level recommendations have not changed since the draft version published in March, except in two respects – one of which limits the scope of the proposals and one of which extends the scope. The CAA has limited its recommendations to international flights, but it has added recommendations for protection of the whole “package” where airlines facilitate the sale of other holiday components by separate organisations.
- 1.4 There are also new passages on the economic impact of the proposals; on the historical context of the problem and the different issues that arise for what effectively appear to be “packages” and for flights; and on interim measures that might be implemented while a longer term solution progresses. A summary of the substantive changes to the draft paper is at Annex 1.

2 Summary of conclusions

- 2.1 The CAA concludes that there is now without doubt a serious issue in relation to the reduced scope of holiday protection, and that unless the law is changed there cannot be the protection for holidays that the travelling public has historically enjoyed and appears to want and expect. Without Government action, the CAA believes the position will deteriorate sharply: doing nothing, and expecting the present level of protection to be maintained, is not a credible option.
- 2.2 The CAA recommends to the Government that:
 - a) There should be a change in the law to extend a statutory requirement for travel protection to cover UK-originating international flights sold by airlines where payment is made in advance. On the same basis as at present, the criteria for inclusion would be that the sale was made in the UK and the outbound flight originated from the UK; this would apply irrespective of the nationality of the airline. The protection would extend to facilities other than the flight where all the components were supplied as a “package” in the terms of the European Council Package Travel Directive¹. Additionally, this definition would be extended to include sales where an organisation selling a flight facilitated (usually through a linked website) the sale of other components.

1 EC Directive (90/314/EEC) on Package Travel, Package Holidays and Package Tours

- b) The CAA considers that ideally this legislative change should be made at European Union level, and it suggests that the Government should make positive efforts to influence the European Commission in this direction. It recognises however that changes in EU law may take some time and that there is a possibility of airline failures which will impact on the public during the interim. The CAA recommends that the Government should introduce UK legislation without waiting for an EU outcome.
- c) In view of the urgency of the problem, the CAA is very concerned about the delay that may occur before even UK legislation is enacted. It has set out some proposals for interim measures that might be introduced on a voluntary basis. Different measures could address the different problems that arise from the sale of linked quasi-packages and from airline flight-only sales, and the effectiveness or otherwise of these would be a factor in making legislation more or less urgent.
- d) The current processes and mechanisms used to provide consumer protection for tour operators' customers are not appropriate for airlines. Further consideration should be given to the appropriate mechanisms to provide protection, particularly in respect of whether a mutual insurance solution or a common fund might replace bonds. Either change would also require primary legislation.

2.3 The above changes, particularly those in relation to scope, would be major steps and the CAA accepts that the Government would not introduce primary legislation without the assessments of practical effects and costs that would be contained in a full Regulatory Impact Assessment. The CAA will in due course prepare the necessary detailed analysis. However, this will require both significant resources and the involvement of those (such as airlines) who would be affected. The CAA therefore judges it right to seek Government's agreement to the principles it recommends on the basis of broad cost estimates, while acknowledging that there needs to be further analysis of how those principles might best be put into practice and the consequent costs.

3 Principal issues highlighted in the consultation process so far

3.1 The CAA's consultation was prompted by evidence that the ATOL system, which has historically provided effective consumer protection for holidaymakers at reasonable cost, would be constrained in its ability to do so in the future because of changed circumstances and legislation that no longer fits the realities of how holidays are now sold. There have been substantial changes in recent years, principally as a result of the availability of cheap flights direct from airlines and the ease with which flights and accommodation can be bought over the Internet: this has led to an increasing tendency for people to buy separate holiday components rather than pre-arranged packages, and these sales fall outside both the ATOL Regulations² (and their primary enabling legislation) and the Package Travel Directive. They therefore carry no statutory protection against the insolvency of any of the suppliers.

2 The Civil Aviation (Air Travel Organisers' Licensing) Regulations 1995

- 3.2 It is relevant to focus on how and why the current consumer protection mechanisms evolved in order to consider how they fall short today. There are two separate strands. The ATOL legislation, which was enacted in 1971 preceding that in the EU by almost 20 years, took as its assumptions that scheduled airlines (which were mainly state owned or at least protected by regulation) would not collapse, and that in any event most individuals buying flights for leisure purposes would do so through a tour operator rather than dealing direct with the airline concerned; the latter assumption was strengthened at that time by the public's lack of familiarity with foreign travel and such factors as currency restrictions. All this led to the view that precautions such as bonding were necessary only for travel intermediaries, not for the airlines themselves. The EU appeared to adopt similar assumptions, but they led it to an explicit view that the need for protection arose in respect of package holidays only.
- 3.3 Most of the assumptions on which the two pieces of legislation are based are clearly invalid today, with perhaps the only one surviving being the basic demand for holidays to be protected. Scheduled airlines, at least within Europe, are no longer supported by state ownership or protected from competition, and as a result failures are by no means unusual. The new strain of no-frills airlines specialises in selling direct to the public, which is facilitated by the Internet, and generally sells non-refundable and non-transferable tickets. Finally, the proportion of holidays now bought as packages has declined sharply, both because it is easy for independent travellers to buy separate components and because many holidays which appear to be packages are legally otherwise as a result of there being separate suppliers. It must therefore be concluded that neither the ATOL Regulations nor the Package Travel Regulations now provide the protection for the substantial majority of holidays and leisure travel that was envisaged by legislators when they were introduced.
- 3.4 The problem of "quasi-packages", where technically no package exists because there are separate suppliers, is aggravated by the fact that many of the flights and other facilities bought separately are to established package holiday destinations which would formerly have been served by tour operators selling a protected product, and by the fact that the Internet sites through which they are available are constructed so that, in many cases, customers do not realise that they are not buying a package. In 2003, the CAA conducted research into customer perceptions which showed a general ignorance on the part of the public about the realities of protection, but yet a widespread expectation that there would be security for their holiday money: expectations varied slightly for types of travel, but people generally believe their money to be secure even where in reality no protection exists.
- 3.5 The concentration of cheap flights sold directly by airlines on dense short-haul leisure routes to places like Palma, Alicante and Malaga is also very relevant to the risk of people being stranded in the event of an airline's collapse. These destinations are often those popular with families and young people, they have distinct seasonal peaks, and transport links to them are dominated by services with high load factors and low on-demand availability. If an airline failed in the peak season there could be considerable distress to customers who were unable (because of either lack of funds or lack of alternative transport) to get home, as well as substantial losses to families who have made advance payments, many of whom are in the lower and middle income categories. The scale of the potential damage is underlined by the size of the airlines involved: the largest UK no-frills airline now carries more passengers per year than the two largest tour operating groups combined. In an environment where competition is continuing to increase, it cannot be assumed that airlines that are strong today will always be so.

- 3.6 A final cause of concern set out in the CAA's earlier paper was that the traditional ATOL mechanism to provide financial protection, bonding, was being undermined by an absence of insurance capacity to provide bonds and a lack of appetite on the part of both banks and insurers for doing so. With the Air Travel Trust in deficit and unable to bear the increased risks that might result from a shortfall in bonding, the CAA questioned whether other mechanisms such as a common fund might be more appropriate.

4 Substance of responses to the consultation

- 4.1 The CAA received 54 responses to its initial consultation and 36 submissions commenting on its draft advice. Most were from travel industry associations, from large and small travel firms, from consumer bodies, from financial institutions and from professional advisers to the industry. There was also some input from Government-related bodies and from airlines.
- 4.2 There was widespread support, from both consumer bodies and the travel industry, for the principle of consumer protection in travel, with only a few respondents suggesting that, instead, the caveat emptor principle should apply. There was also general agreement with the CAA's comments to the effect that the current system was complex and fragmented, that customers did not understand what to expect or what to look for and that it was difficult to defend the distinctions that were based on historic accident rather than on need or rational analysis. Many travel firms and their representatives qualified their support for consumer protection by the comment that it must apply consistently to travel providers, both in the consumer interest and for competitive reasons. A large number of responses pointed to what they saw as an anomaly, namely that travel sold direct by airlines and accommodation supplied separately were outside the ATOL system and there was no statutory requirement for customers to be provided with security against the insolvency of those suppliers.
- 4.3 There was however less agreement on the scope that would be desirable, and indeed very little analysis of how that scope should be determined. It was fairly common ground that transactions should be excluded where there was no advance payment involved, and most contributors argued that the no-frills airlines should be included in the protected area. Other than this, there was a range of suggested coverage including all air travel and air travel packages; travel and travel packages, whatever the means of transport; and travel-related facilities, sold separately or together. Even among those who tended to the comprehensive, it was acknowledged that it might be difficult to regulate foreign hotels and other suppliers with whom UK customers booked directly, though some people suggested that there could be regulation of these facilities where there was a UK presence.
- 4.4 The main associations representing the travel industry indicated in response to the CAA's first paper a strong preference for a unified system that incorporated all modes of travel. However, they acknowledged that it would be difficult to show a strong case in view of the historic lack of problems in the surface travel sector, and they supported the CAA's proposals, though some noted that they retained a unified system as a long-term objective.

- 4.5 At each stage there was input from consumer bodies – the Air Transport Users Council and the Consumers' Association – and also from the Air Travel Insolvency Protection Advisory Committee which includes independent and consumer representatives and has a formal role in advising the CAA and Government on insolvency protection issues. All these bodies expressed clear support for the CAA's proposals, though the Consumers' Association stated concern about the accommodation element of quasi-packages. ATIPAC said that it regarded an overhaul of the system as a matter of urgency, and voiced reservations about whether voluntary measures could be a substitute for regulation.
- 4.6 In view of the fact that many respondents advocated an extension of protection to scheduled airlines' customers, the CAA was particularly concerned to obtain input from airlines. At the earlier stage there was some input, though most scheduled airlines offered no arguments of principle that they should be excluded from a protection scheme except for suggestions that their customers are already protected in some cases and that airlines fail more rarely than tour operators. The latter may still be true in absolute terms, but the premise that scheduled airlines will not fail is surely difficult to adopt in view of a significant number of recent failures in both Europe and the USA. It was suggested that IATA airlines should be viewed differently from others in that there are arrangements in place to deal with failures, but recent experience has indicated that it is difficult to place reliance on these: in any event, the non-IATA sector is substantial in terms of total UK-originating traffic. The no-frills carriers argued that the move would raise costs and depress demand, and that for very low ticket prices they believed that customers did not care whether they were protected or not.
- 4.7 In response to the draft advice, many of the above arguments were repeated, but some new points emerged. The full service carriers were unanimous in believing that the real problem lay with the particular selling methods of the no-frills carriers and suggested that extending coverage only as far as quasi-packages would be sufficient to restore the coverage that the current legislation envisaged. A variant on this theme was the suggestion that the full cover offered for packages or quasi-packages might be supplemented by a requirement to offer travel insurance, as a matter of customer choice, for flight-only sales.
- 4.8 Some respondents, including airlines, suggested that credit cards offered financial protection that was an adequate substitute for a statutory protection system. However, the protection given by credit cards is patchy because various significant categories (purchases through travel agents, payments for groups, payments for third parties and amounts of less than £100) are excluded; debit cards also give no statutory protection, and the fact that airlines usually levy a significant premium for on-line or telephone bookings using a credit card results in debit cards being increasingly used for ticket purchases. The number of low fares offered by no frills airlines also results in there being no protection because of the £100 threshold on a significant number of occasions when a credit card is used. The public may therefore place more reliance on card protection than is justified, and card issuers' liability of course does nothing to deal with the issue of repatriation. Finally, there is a draft European Council Directive which would if approved in its current form remove the liability from card issuers in these circumstances.

- 4.9 Several airlines regarded financial regulation as a means by which airlines could be wound up while they still had sufficient funds to organise repatriation and pay refunds themselves. The CAA does not believe that this is realistic: the only actions that could be taken by a regulator when an airline was in difficulties would be to revoke its licence or to warn the public that their money was at risk if they continued to make bookings. Both these actions would be likely to have the effect of an immediate collapse unless the standards required for licensing were such as to be a significant barrier to entry. Further, the CAA has no control over the financial regulation of non-UK air carriers.
- 4.10 It was suggested that protection against airline insolvency was or could be provided by travel insurance: some airlines initially appeared to be unaware that most travel insurance policies do not cover customers against scheduled airline failure³. Others were aware of this but suggested that suitable travel insurance covering airline failure could be devised. This is no doubt true technically, though whether in the current trading environment it would attract sufficient underwriting appetite is another matter; further, if customers were left to choose whether or not to buy insurance, many might fail to do so because of lack of understanding about the risks. There are also issues of enforceability (if a mandatory requirement was considered), of exclusions and of the need to arrange repatriation.
- 4.11 The CAA's published draft advice suggested that the cost of a levy would be offset to a significant extent by a reduction in airlines' credit card charges if the liability for insolvency was removed from card issuers. Some airlines argued that this was overstated, and the point was confirmed by credit card merchant acquirers; although the CAA remains of the view that a small offset would occur, it has not placed emphasis on this offset in its final conclusions.
- 4.12 On protection mechanisms, the CAA's paper noted that bonding availability was under pressure and that bond prices, particularly for the largest companies, had risen sharply. It is unsurprising that responses were heavily against bonds and in favour of a common fund; in some cases the view depended on the scope of protection being extended to scheduled airlines, and acknowledged that bonding capacity would not be available to cover this sector. A number of responses suggested that a fund could be operated on the basis of contributions of £1 per head but, although that figure has become common currency, there was no analytic base put forward to support it. Some respondents cited the Dutch system as being an example to follow, indicating that it was based on a simple fund with a stamp issued to evidence protection: however, the CAA has researched the Dutch system and finds that it is not in reality particularly simple, with the fund being only one element of protection. There is no stamp.
- 4.13 There was no appetite for trust accounts except from the small number of organisations who currently operate these: most respondents acknowledged that this would require too great a shift in the basis on which the industry is financed, since most companies need to use their advance payments for working capital.

3 The CAA examined a sample of 25 insurance policies sold either on line or through agents. Only three provided cover against scheduled airline failure.

5 The scope of protection: principles

- 5.1 The CAA has given consideration to the principles that should govern what the scope of protection should be, and has identified specific options which are in general within the range suggested by respondents to the consultation.
- 5.2 The current system of holiday protection originated from a political decision about the impact of tour operator failure on the public, rather than from an analysis of economic benefit. The principles involved consumer expectations; the possible loss of large sums from family budgets; and the problem of passengers being stranded in resorts without funds or adequate transport systems for them to make their own way home, with the likelihood that people would expect Government generally to assist them. In setting up a protection scheme, it was also important to have an equitable system with low barriers to entry which allowed market needs to be fully met and did not distort competition.
- 5.3 The issues that the CAA regards as central to the current consideration include the following, which are discussed further in this section:
- **Decline in protection:** the impact of recent changes in buying patterns and the extent to which the effectiveness of previous legislative steps to provide protection is now being undermined. In the view of the CAA, there is no option whereby we can “do nothing” and expect that things will stay as they are in terms of holiday protection. The fundamental choice lies between:
 - continuing with the existing legislation framework and accepting that the decline in the proportion of holidays protected will accelerate; and
 - extending the scope of the scheme of holiday protection so as to arrest that decline.
 - **Demand for protection:** aspects of this are the extent to which it is the norm in the UK for significant advance payments to be protected; the value customers place on protection of advance payments in different circumstances, and how that can be balanced against the costs of providing it; and the value of a system that ensures that customers are not stranded in places from which it is difficult to arrange their own return.
 - **Practicality:** some issues here are the importance of simplicity, and the difficulty of giving clear information to customers about a system with complex boundaries; and how far information may be a substitute for protection, or voluntary measures a substitute for statutory requirements.
 - **Competition:** the distortion of competition that may result if firms serving the same market have different regulatory requirements and different cost levels in consequence.
 - **Conformity with European legislation:** the need for solutions to comply with current European legislation.
 - **Conformity with Better Regulation principles:** the need for solutions to reflect the principles of the Better Regulation Task Force.

Decline in protection

5.4 An indication of the scale of the increase in unprotected holidays is shown in Table 1 below, which updates the data in the CAA's earlier papers.

	ATOL	Air holidays	Visits to friends and relatives	Holidays plus VFR	ATOL / Holidays plus VFR
	Return trips, million				%
1989	12.9	15.5	2.4	17.8	72
1990	11.6	14.5	2.7	17.2	67
1991	10.6	13.6	2.6	16.2	66
1992	13.3	15.9	2.9	18.8	71
1993	14.7	17.5	3.1	20.6	71
1994	17.0	19.4	3.3	22.7	75
1995	19.1	19.7	3.5	23.2	82
1996	21.3	18.4	3.8	22.2	96
1997	23.5	19.9	4.1	24.0	98
1998	25.0	22.9	4.4	27.4	91
1999	26.4	25.3	5.0	30.3	87
2000	28.0	27.9	5.6	33.5	84
2001	29.1	29.8	6.0	35.9	81
2002	27.9	30.5	6.3	36.8	76
2003	27.6	32.6	7.0	39.6	70

Sources: CAA and ONS

5.5 These figures show that –

- the proportion of total ex-UK international leisure passengers protected by ATOL has fallen from a peak of 98% in 1997 to 70% in 2003;
- in the last two years, the respective falls have been five and six percentage points;
- the proportion protected is now as low as in the early 1990s, despite two legislative measures (the Package Travel Regulations⁴ in 1992 and amended ATOL Regulations in 1995) which were intended to ensure that almost all holidays were protected and which resulted in significant increases between 1992 and 1997 in the proportion of leisure travel covered by ATOL; and
- since 1996, ex-UK international leisure flights and holidays (packages and visits to friends and relatives) have increased by 17.4 million or 79%: in the same period ATOL coverage has increased by 6.4 million or 30%. This suggests that an additional 11.1 million holidays not covered by ATOL were taken in 2003 compared with 1996, and the rate of increase in this figure is now 2-3 million per year.

4 The Package Travel, Package Holidays and Package Tours Regulations 1992

- 5.6 It seems to the CAA important to emphasise that without regulatory change there is no reason to expect a reversal in this trend, which is driven by a demand for cheap flights and by technology which enables holiday components to be bought separately; these driving factors will remain. Indeed, if no regulatory action is taken the trend may in reality increase more sharply in the future as a result of competitive reactions by the major tour operators, who may rearrange their businesses to avoid the costs of protection.

Demand for protection

- 5.7 A comparison with other consumer purchases in the UK suggests a tendency for significant sums of money paid by consumers in advance of receiving any benefit to be protected, though this is not wholly consistent. Savings and investments, for example, are in the main protected by law and a range of other major advance payments are protected by a mixture of statutory and voluntary schemes, including mail order protection and the protection that attaches to credit card purchases through the Consumer Credit Act 1974. There is however no security for major household purchases paid in advance where the payment is made by means other than credit card.
- 5.8 We have only limited direct pointers to the value that customers place on holiday protection. The CAA's survey suggested people travelling within Europe regarded financial protection more highly for beach holidays, the majority of which are still bought as packages, than for city breaks and visits to friends which are more likely to be independently booked. Even in the latter categories, however, 45% or more of respondents regarded financial protection as very important and 73-77% regarded it as very important or quite important. For long haul holidays, people regarded financial protection very highly whether they were booking a package or not.
- 5.9 However, it was not possible to add tension to the choice by establishing how much customers would be prepared to pay if the cost were added explicitly to travel prices. The CAA has therefore to rely on surrogates such as the travel industry, which believes that protection enhances its product, and consumer organisations. In response to the consultation there was a virtually unanimous demand from travel industry associations and consumer organisations that the scope of protection should be extended at least to cover air holidays sold in circumstances which the public cannot distinguish from those where protection has traditionally applied.
- 5.10 The CAA's research indicated that the value attributed by the public to protection varied according to kinds of travel, and it is reasonable to query whether the value of protection for low priced air fares can justify the costs of providing it; this raised the possibility that protection might apply only for sums above (say) £100. However, few respondents favoured a minimum price. This may be partly because if passengers have to buy tickets to get home after an airline fails, the price of these tickets can far exceed the price of the original ticket; and partly because a minimum price would add a further complication to the protection framework while most respondents urged greater simplicity. It is in any case worth noting that holiday deposits are typically slightly less than £100 per person, but for a family of four the loss of deposits would not be insignificant; and that for packages, a minimum price would not comply with the current Package Travel Directive.

- 5.11 The consultation indicated that repatriation was still valued highly, and several respondents pointed to the problems that could follow the failure of a large no-frills carrier. The potential distress to passengers “stranded” abroad does not by any means apply on all scheduled routes where alternative transport is readily available, but the recent failure of Duo Airways illustrated that even on predominantly business routes it is not always easy for passengers to find alternatives; many had to pay substantial sums to get home, despite Duo’s membership of IATA. If an airline serving sunspot resorts failed in the peak holiday season, passengers could face huge delays as well as high prices because the nature of services is such that on-demand flights would not be available. It has also to be stressed that some holidaymakers are more able to take care of themselves in these circumstances than others, and that while some can pay for their own return many have neither credit cards nor money readily available at the end of their holidays.
- 5.12 In the event of the collapse of a major airline serving holiday resorts, the CAA believes that it is unlikely that Government would be able to accept the consequences to holidaymakers without having to intervene; it is possible that assistance would need to be provided to repatriate stranded passengers at a significant cost to the taxpayer. This would follow the pattern established before the 1972 legislation which established the ATOL structure, when there was a frequent need for the Foreign & Commonwealth Office to provide assistance to passengers stranded abroad after the failure of travel companies. It is worth noting that the scale of overseas leisure travel covered by ATOL now is more than ten times greater than when the system was introduced, and the scale in the non-ATOL sector is moving towards similar proportions.

Economic impact

- 5.13 The needs outlined above will be seen in the context of the cost of providing protection. The CAA has made clear that its assessment of costs will need to be refined in the light of better information on a number of variables, but we have made a broad assessment of the number of passengers that might be affected and an estimate of the size of fund that might be required. The following is based on the assumption that the mechanism for protection would be a fund or a mutual insurance instrument, into which the whole of the industry (airlines and tour operators) paid at a uniform rate. For tour operators currently covered by ATOL, the fund would replace the current need for bonding.
- 5.14 The CAA believes that it is reasonable to suggest that a levy on the scale envisaged will effectively be passed on by airlines and tour operators to the public; as with fuel price increases, some may prefer to identify it explicitly while others may absorb it in general costs. Leisure air travel is a competitive and low-margin business, and in general there is a need to recoup additional costs fully to maintain profitability. The CAA accepts that a part of the market is price-sensitive and that in some cases there may be an interval before a levy is passed through in full. However, the CAA does not believe that any real distinction can be drawn between a levy and any other tax or industry-wide operating cost, and larger amounts in taxes have historically been passed on.
- 5.15 The cost of the levy will thus ultimately be entirely borne by customers, all of whom will pay higher prices because of the levy and some will receive benefits (in the form of repatriation and refunds) out of it. No payments will be made other than for the benefit of consumers, so the scheme will be cost-neutral for customers as a whole except -

- a) for administration costs. The costs of managing ATOL are currently about 15 pence per passenger;
- b) where there is duplication, for example where customers are already covered by credit cards or insurance. The risk element of credit card charges in a competitive market should however reflect liability and should reduce if the liability does not exist. In the small area where there is insurance at present, the overlap would not continue: a centralised system should properly be cheaper because of risk pooling; and
- c) where there is inefficiency, for example where a fund erodes because it does not earn a return that keeps pace with inflation, or because of insurers' profits.

5.16 The CAA has prepared some provisional figures that illustrate the costs that such a system might incur. We have assumed that travellers would pay a levy for a period during which a fund large enough to meet a single major failure was built up: once that fund was in place, no levy would be necessary until failures had depleted the fund. For a system covering UK originating international flights paid for in advance⁵, a levy of a little over £2 per passenger would build up a fund of about £560 million over five years, which would be sufficient to cover a peak season failure of one of the largest tour operating groups; we estimate the amount needed to cover the failure of one of the largest airlines would not exceed this sum. In the first year, if there was no major failure, then the industry (tour operators and airlines) would gather about £112 million per annum in levy payments and pay about £8 million in fees. In due course, all of the levy payments would be used for the benefit of travellers apart from the relatively minor element of administration costs. The annual cost in the build-up phase could of course be changed by accepting a longer or shorter period for building up the fund to its target level, or by a different assessment of the size of fund that is desirable. The costs and the length of this funding period could also be affected if there were a failure of significant size in the early years although, based on the historic annual cost of ATOL failures, we consider it unlikely that the calculation would change in a major way. The costs of a major failure in the initial funding period could be smoothed by an insurance instrument, though this would carry a net cost which would affect the cost neutrality outlined above.

5.17 The figure of £2 per person suggested above would apply to both tour operators and airlines. For the former, the cost would be roughly equivalent to the current average cost of ATOL bonding and there would therefore be no increase even in the short term: the significant benefit would be that after the funding period the contributions would decrease or cease until the cumulative effect of failures made replenishment necessary. For airlines, there would be a new cost during the funding period, though as noted the CAA would expect this to be fully passed through to customers.

5.18 In each year, the costs will be equally spread among consumers whereas the benefits will be concentrated in a few. Similarly, people who travel while a levy is being charged will in the short term be subsidising those who travel only after it is suspended. These factors are typical of insurance solutions, but do not invalidate the principle of broad cost neutrality.

5 The CAA has at present no analytic base on which to estimate the proportion of traffic that is paid for in advance. It has adopted a provisional assumption of 50% of business traffic.

- 5.19 There will inevitably be a net cost arising from at least the administrative cost, though this may be small relative to the overall costs and benefits and has to be set in the context of the value attributed to such intangibles as “peace of mind” and the removal of the risk of massive repatriation problems.
- 5.20 It can be argued that price elasticity will result in a reduction in output if a levy is added to air fares. However, the sums paid will be very small relative to average prices and to other taxes and cost increases that have been fully passed on over a period. Further, it can equally be argued that good protection in the ATOL area has historically helped consumer confidence and increased the market.

Competition aspects

- 5.21 Many respondents to the consultation, particularly tour operators and their representatives, drew attention to the contrast between the regulatory regime with which tour operators comply and the absence of any such requirements for no-frills airlines; they argued that the current scope of regulation led to a distortion of competition, since there are no corresponding costs for airlines.
- 5.22 One dimension of this aspect, which was emphasised in the CAA’s previous paper, is whether this is a matter of free choice on the part of customers: if people have a choice between an unprotected product and one that may be more expensive but superior from the point of view of security, this might be regarded as a benefit in terms of healthy competition. The potentially distorting issue here, however, is the evidence that customers are largely unaware of the difference in protection and tend to assume that security exists where that is not the case.
- 5.23 A central point of competition analysis is to define the relevant market and consider whether the participants may both be regarded as serving it, with the effect that customers may be expected to switch between suppliers; in this instance, the issue is whether scheduled airlines serve the same market as charter airlines and tour operators. It is reasonable to suggest that business traffic is a separate market in which customers would not switch from scheduled to charter airlines, particularly given that business traffic is highly destination specific and that predominantly business routes are not served by charter airlines. However, for leisure traffic it is equally reasonable to assume that people might choose to buy from either an airline or a tour operator where both offer services to the same destinations or destinations with similar characteristics.
- 5.24 It is relevant therefore to consider the split between business and leisure traffic carried by scheduled airlines. In the case of UK no-frills carriers serving international routes, the proportion of ex-UK international leisure traffic varies between routes to traditional resorts, where it constitutes more than 90% of total carryings, and routes to city destinations where the proportion is lower: even on the latter routes, however, leisure traffic tends to be in the range 60-80% and is occasionally still higher⁶. Although many people buying seats on no-frills airlines to holiday resorts would alternatively travel on a charter seat-only basis rather than buying a package, their prices for charter flights bought from a tour operator would still include an element of licence and bond costs.

6 The illustration quoted is based on the CAA 2002 O&D survey figures for the leading UK no-frills carrier, taking UK residents travelling on international routes only.

- 5.25 For scheduled airlines generally (although there is no definition that precisely separates no-frills airlines from full service airlines, and the distinction is blurred in practice), there is similarly a distribution between leisure traffic that might or might not be bought through a tour operator and business traffic which would not book through a tour operator; the proportions will vary widely by route. Much of the business traffic carried by full service scheduled airlines would not however be paid for in advance and might not be affected by a protection scheme.
- 5.26 A further consideration in how far no-frills carriers serve the same market as tour operators is the availability of charter services on various routes: on short-haul routes where there are no charter services, there are (and in recent history have been) very few flight-onlys covered by ATOL available, though there are ATOL protected packages using scheduled flights and historically have been more than there are now. This test again indicates a substantial commonality on resort routes like Malaga but a much smaller one on routes like Amsterdam which is not a traditional charter destination. Overall, the CAA concludes that the extent of overlap in markets between no-frills services and those of tour operators is variable by route, but it exists on most international routes served and is very substantial on some, particularly the major holiday destinations.
- 5.27 There is also a broader sense in which customers may switch between scheduled and charter services. The geographic area served by the no-frills airlines is at present limited to shorter European routes and to the Western Mediterranean. However, for leisure traffic, there is no reason to suppose that their competitive impact is limited to these areas as some elements of leisure demand are likely to be fluid between these and other destination areas like the Eastern Mediterranean.
- 5.28 If it is accepted that at least the no-frills airlines compete directly with tour operators for a substantial part of their operations, the question that next arises is whether the regulatory costs are significant. The average cost of bonds is now almost £2 per passenger and it may be much higher for some smaller firms, and licence fees amount to about 15 pence per passenger with compliance and reporting costs being additional to this. The total (exclusive of compliance costs) is about 0.46% of the average ATOL protected holiday price, though on very short haul routes with a high proportion of seat-only traffic the ratio may be higher because there is a small fixed element. These routes also have low margins.
- 5.29 Regulatory costs are not the only differences in costs between no-frills airlines and tour operators: for example, the latter generally have an advantage in lower seat costs by virtue of larger aircraft, and they also have higher load factors. The operating cost differences may well be more significant than the licensing and bonding costs but they appear to the CAA to be in a different category from costs imposed by regulation. The CAA regards it as a proper obligation on a regulatory system that it should not distort competition: in view of both the overlap between the respective markets served and the costs resulting from the current regulation of tour operators, it suggests that the current arrangements do not meet that obligation.

Simplicity

- 5.30 The desire for simplicity, which is an aspect of the practicality of a scheme, was a common theme of responses, and apparently influenced both the desire for a common fund and the wish for an across the board system that encompassed surface travel as well as air. The CAA regards simplicity and ease of understanding by customers as a legitimate objective, but it is one which will often be in conflict with the objective of minimising cost and intervening only to the extent that actual

circumstances justify. The objective of simplicity taken in isolation might, for example, suggest that a comprehensive system covering all modes of transport would be a benefit, but the CAA finds it difficult to accept that there are equally compelling needs in all sectors or that such coverage is economically justifiable.

Disclosure and information

- 5.31 The CAA considered with some care the possibility that there might be less of a need for full statutory protection if customers fully understood where protection applied; people could then choose between a protected product and a (possibly cheaper) unprotected one, or take action as appropriate to buy insurance. A statutory requirement for firms to disclose where no protection applies might be a constructive step towards enabling customers to decide their own preferences and to act accordingly. This concept might also extend to a requirement to state that products offered in such a way that they would be bought in combination were in reality unrelated and that no protection applied to one or the other component. In principle, these steps could be regarded as an enhancement of customer choice and a positive benefit.
- 5.32 In its earlier consultation paper the CAA raised questions about how effective a disclosure requirement might be, and about its enforceability. One problem is that the CAA's survey indicated that customers tend to assume that protection exists rather than to research the point, and in order for them to understand the reality it would need to be stated in a very clear and obvious way. The information that money is at risk is a negative message and it is not realistic to expect that airlines would promote it very proactively, though they might voluntarily include a statement in their conditions of booking. Transactions conducted through the Internet commonly involve such a statement of terms and conditions, and customers are required to signify that they have read these before they can proceed to the next stage of purchase; however, anecdotal evidence suggests that most people signify this without actually doing so. A formal requirement would probably therefore be ineffective unless it was heavily prescriptive in terms of the positioning and size of the message. This in turn suggests that a disclosure requirement would require considerable policing, and it is not clear how the significant costs would be recouped from the airlines that should properly bear those costs.
- 5.33 It has been suggested that both the CAA and the industry which sells protected holidays could do more to make the public aware of the benefits of ATOL protection. The CAA does not discount this suggestion and it already provides a large quantity of information through leaflets and websites; it is also currently working with travel agents and tour operators to emphasise to customers the benefits of the security they provide through ATOL, with some useful progress. However, while more can be done in these areas, the CAA recognises that there are limitations. The current distinctions in terms of where protection applies are not easy to understand: customers moreover tend to have no great interest in the source or details of protection until they are affected by a collapse, or at least have particular reason to be aware of the possibility of one. The unwillingness of tour operators to emphasise protection reflects these factors, and also that in most circumstances tour operators are reluctant to emphasise that they might become insolvent. The alternative of providing information direct to customers through advertising would be an expensive option, given the relatively low level of interest: experience in this area has shown that advertising campaigns have to be both significant and sustained to show any lasting results, and such expenditure would require funding well in excess of current budgets.

- 5.34 The CAA recognises that more can usefully be done to raise public awareness, although this will carry a cost. However, for the reasons indicated above, the CAA does not believe that increasing the public's understanding in order to allow it to make informed choices is a realistic way of dealing to any great extent with the fundamental problems the CAA has outlined, even in relation to the protection of advance payments. The public is neither inclined nor very well equipped to appraise the "fine print" which accompanies matters such as insurance and credit protection, and the transaction between consumer and tour operator or airline will always be asymmetric as regards information about terms and conditions and financial status of operators. A disclosure requirement will not prevent some holidaymakers from taking risks, whether knowingly or not, and will not deal at all with the problem of people being stranded abroad. These fundamental difficulties are unlikely to change.

International aspects

- 5.35 The UK's framework for travel protection is longer established than that in some countries but it is by no means unusual in its objectives and mechanisms. The CAA has conducted research into the extent to which travellers are protected against insolvency in other countries and has found that virtually all major economies with a significant outbound tourism sector (and the USA, where the majority of the traffic is internal) have some form of protection. In the EU, the Package Travel Directive requires protection to be provided, and in evaluating the possible options, the CAA has concentrated on those that would comply with current European legislation.
- 5.36 Given the increasing harmonisation of consumer legislation in the EU, it would clearly be preferable for change to be achieved at EU level rather than by the UK acting unilaterally. The changes that have produced the problem in the UK (the growth of the no-frills carriers and the accessibility of direct airline and accommodation sales through the Internet) affect other Member States and some have suffered the consequences of a number of recent airline failures. The CAA expects these consequences, and the extent to which the effectiveness of the Package Travel Directive is now being undermined by sales of separate components, to be a matter of concern at European level. The European Commission has tendered for a study into scheduled airline insolvency and passenger protection and there is a possibility that there will be a review of the Package Travel Directive in the future, which in part will consider similar issues. However, it is not clear how far these moves will obtain the priority necessary to produce legislation within a reasonable time.

Better Regulation principles

- 5.37 The CAA has approached this issue with the principles of Better Regulation in mind, and has been concerned to be accountable and transparent by consulting fully and by explaining its analysis in some detail. It sees consistency as a benefit that would flow from the changes it proposes. It has also been conscious of the need for proportionality and targeting, and has balanced the need to target protection precisely where it is needed against the need for a system with simple boundaries that the public can understand.

6 The scope of protection: options

6.1 From the issues discussed above, the CAA identified and considered a number of options for the scope of protection. It has not spent time evaluating the truly minimum option of deregulation – partly because few respondents favoured this, but also because of the need for compliance with the Package Travel Directive. The options identified are summarised in the table below with brief comments about the issues raised.

	Scope of statutory system	Issues
1.	No repatriation or protection of advance payments for travel.	This would deregulate the market and leave customers to obtain whatever cover might be available without a statutory requirement, and would remove the perceived competitive imbalance. It was not advocated except by a very few respondents, and for packages it would not comply with the Package Travel Directive.
2.	Repatriation only, for UK-originating ⁷ travel sold in the UK together with other facilities as a “package” as defined by the Package Travel Directive.	This might be regarded as the minimum acceptable. Removing protection for advance payments was not however favoured by trade or consumer respondents. For packages, it would not comply with the Package Travel Directive.
3.	Repatriation and refunds for UK-originating travel sold in the UK together with other facilities as a “package” as defined by the Package Travel Directive.	This would be the minimum required by the Package Travel Directive, assuming the continuation of a statutory scheme: there has been no indication that the industry bodies would be willing to provide an alternative. It would exclude the flight-only sales that are currently covered by ATOL, and in that respect it would partly address the perception of unfair competition held by charter operators at present. However, <ul style="list-style-type: none"> • there was no support among respondents for this; • it would not address the real issues of unfair competition and lack of customer understanding because of the absence of protection for quasi-packages where separate holiday components are bought from different but linked suppliers; it is doubtful whether it would be sensible to define a system on the basis of “packages” because of a trend towards buying separate travel facilities.

⁷ The term “UK-originating travel” throughout this paper includes return legs of round trips where the outbound flight started in the UK, even though the two legs were ticketed separately.

4.	As 3, but additionally “packages” where an airline selling a flight facilitates the sale of other holiday components. This would extend to combinations of flights and travel facilities sold by different suppliers through linked websites, which at present are outside the scope of the Package Travel Directive.	<p>This would come nearer to addressing the perception by customers that holidays bought through linked websites are packages and therefore protected, and also the perception of unfair competition by charter operators at present.</p> <p>However, a restriction would need to be carefully defined in order to ensure that it was enforceable. It is also questionable whether it is right to offer no protection for flights which form part of holidays that are genuinely independently booked: although it is not practicable to protect ground arrangements booked direct with foreign suppliers, there remains a case for protecting the flight element in this growing market segment, and this case is strengthened by aspects such as the requirement for repatriation to be organised.</p>
5.	All UK-originating travel sold in the UK, on its own or in a “package” as defined in 3 above. This would add air fares and other travel sold on its own to the “package” options above and would extend the current scope (as far as air travel is concerned) by the inclusion of flights sold direct by airlines.	There was significant support among respondents for this option. In terms of the perceived gap in customer protection for air “packages” it would ensure repatriation both within the current area and following a scheduled airline failure, and it would cover quasi-packages where flights were sold by airlines in association with ground facilities. Ground facilities would not be protected where they were booked completely independently and direct from a foreign supplier.
6.	All UK-originating travel and travel-related facilities, sold separately or together in the UK. This would cover air fares and other travel sold on their own; hotels and car hire sold on their own; or any combination of these.	This is the largest scope for which there was support, encompassing all modes of transport and all facilities. There may be questions over the value of protection for business fares and other facilities invoiced in arrears; low value air fares and travel-related items; and over the practicability of protecting bookings made direct with foreign accommodation suppliers.

The options in 2-6 above could each be modified as follows:

a)	To apply only where payment is made before the customer has completed travel.	There seems little argument for protection where payment is not made in advance. On business-oriented routes it is assumed that there would not be a shortage of capacity for repatriation.
b)	To apply only to air travel as far as a central system is concerned (though there would continue to be a Package Travel Regulations requirement to cover surface travel by other means).	There is no clear difference in logic that can be drawn between air and other travel, and a majority of respondents argued for all travel to be covered by a single system; to limit it to air will still leave multiple arrangements and potential confusion. However, the potential for customer distress is lower for surface travel (where return travel is easier) and the sums involved may be lower. There have been no great difficulties in this sector without licensing and it may be questionable whether the returns could justify the significant costs.

c)	To apply to international travel only	Domestic flights are less likely to be part of a package or quasi-package, and there are no significant repatriation issues involved. Their exclusion from the scope of protection would remove a significant part of the anomalies that might arise from providing protection for very low fare flights. From the point of view of customer perceptions, the distinction is one which should be easy to make clear.
d)	To apply with a minimum expenditure of £100 to apply in respect of refunds, but not for repatriation.	It has to be queried whether the principle of being valued by the customer implies that it is necessary to refund very low fares. However, if this restriction applied per person it could still involve a significant loss in deposits in a family booking. There was little support for a cut-off in the consultation, and it would militate against the popular demand for simplicity – particularly as it could not apply to true packages. Finally, there may be enforcement and collection issues because fare levels fluctuate.
e)	To apply only to journeys within the EU.	This would have a pragmatic value in dealing with most of the area in contention, where charter operators compete with no-frills airlines, and in avoiding some potential political difficulties with foreign airlines where the returns would not be high. However, it was not proposed by any respondents. As with modification c), it would militate against the popular demand for simplicity, particularly as it could not apply to true packages. From the point of view of consumer benefits it might also be seen as irrational, since it would mean that there was no protection where the potential loss was greatest or where the research showed that customers most valued it, and it would mean that repatriation was not available from some areas where it was particularly needed.

7 The CAA's recommendations on the scope of protection

7.1 Of the above options, the CAA's preference is for a modified option 5. It believes that statutory protection should apply to all UK-originating international flights sold in the UK, by airlines based in the UK or elsewhere, where payment is made in advance. Protection should extend to packages, including in circumstances where an airline facilitates the sale of other holiday components although legally no package will exist in these circumstances. The CAA judges that this extension of the current scope of protection would deal with the major concerns that respondents have cited and the most significant area of unprotected holiday sales.

7.2 The CAA believes that there is strong evidence that the need and demand for consumer protection in air travel remain, but it regards the conclusion as inevitable that ATOL does not now provide the protection that was envisaged when it was set up and will be increasingly unable to meet the public's expectations. There are essentially two reasons for this. The first is that under EU legislation holiday protection is required only for "packages", narrowly defined as components that are provided by the same supplier: many quasi-packages are however now arranged

so that there are separate suppliers, although the product is often presented in such a way that the customer does not appreciate that no contractual package exists. The second reason is that the assumption behind the ATOL provisions, that leisure travellers will normally deal through intermediary travel firms rather than direct with scheduled airlines, is also now unreliable, as is the expectation that airlines will not normally fail financially. Two distinct categories of traveller, those who buy quasi-packages from airlines and those who make independent holiday arrangements dealing direct with airlines and other suppliers, are now therefore unprotected, and both categories are growing rapidly. In the CAA's view there is increasing exposure to the public from airline failure. This could involve significant sums paid in advance for family holidays, or large numbers of people stranded in resorts where practical circumstances make it difficult for them either to organise their own return to the UK within a reasonable period or to find and pay for accommodation during their additional stay.

- 7.3 The CAA accepts the objective of a market for air services that is as free as reasonably possible from regulatory barriers but, given the clear intention to protect customers who buy package travel, it is not persuaded that there is any proper basis for a distinction between airlines and other travel firms in terms of a requirement to provide protection: the organisations and their products are increasingly indistinguishable. This points to a conclusion that a reasonable system should encompass both airlines and tour operators, or it should encompass neither. The responses to the CAA's consultation led it to believe that the latter course was not what the public wanted or expected, and the political considerations that led to the setting up of the ATOL system remain valid. In any event, the current terms of the Package Travel Directive would not permit a withdrawal from providing protection, and although the European Commission is reviewing this subject there has been no suggestion that a reduced requirement for consumer protection is a likely outcome.
- 7.4 During the course of the CAA's consultations, various parties argued that an extension of the scope of statutory protection was unnecessary because a range of non-statutory measures currently in force already gives some protection; the measures include voluntary repatriation arrangements through IATA, credit card issuer liability and travel insurance policies. The CAA acknowledges that each of these instruments can give some benefit to customers in some circumstances, but as outlined in Section 4 the overall result leaves significant gaps which are certainly not recognised or understood by the public. The CAA therefore does not believe that these measures can be regarded as an acceptable substitute for statutory protection.
- 7.5 The CAA recognises that there would be cost implications in the proposed change, but it believes that over a period the costs would be passed on to the customers as other costs and taxes are; the customers who want protection would then bear the costs and there should be no long term effect on airlines' profitability. Although there needs to be further work on the details of whether protection would best be provided by a fund or whether there is a place for other mechanisms, the CAA sees no reason to believe that an efficient mechanism cannot be put in place so that customers receive a benefit from a mutual arrangement commensurate with the contribution they make to it.
- 7.6 The CAA is also convinced that the current ATOL system will not remain viable or credible if regulators and legislators do not respond to the considerable dissatisfaction with current anomalies that has been expressed by respondents. The proportion of holidays covered by ATOL continued to decline in 2003 and there is scope for the largest operators to rearrange part or all of their businesses by

switching their flight sales direct to their airlines in response to what is at least perceived as a competitive anomaly. The result would be a loss of credibility for the ATOL system, a loss of clarity and simplicity from customers' point of view and a further distortion of the market because of a disproportionately high cost for small operators still covered by the system. The purposes for which ATOL was set up would be increasingly frustrated.

- 7.7 The CAA attached importance to the need to balance benefits and costs, and accepted that in the case of very low fares the argument for intervention is perhaps less strong. It considered with care whether it should recommend a minimum threshold of say £100, below which no protection (at least for advance payments) would apply. However, this might still lead to significant losses in family holiday bookings and it would create additional complexity, particularly as it could not apply to packages because of the Package Travel Directive requirements. It would also be complex administratively since there would need to be funding, presumably at a lower level, if a repatriation requirement remained, and it would be difficult to enforce bonding or contributions at the proper rate because fare levels fluctuate. The CAA concluded therefore that the disadvantages of a minimum threshold outweighed the attractions.
- 7.8 The CAA did however conclude, after considering comments made on its draft advice, that the case for including domestic travel was significantly less strong than where international flights were concerned. Few domestic flights form part of package holidays and there is usually no significant repatriation issue: further, flights within most of the UK compete directly with rail services where no protection is provided. The CAA suggests that excluding domestic flights from the scope of protection would, while not being uncontroversial, remove a significant part of the dilemma that arises when protection is attached to very low air fares sold on their own.
- 7.9 The change recommended would not deal with advance payments for accommodation bought independently, but in the CAA's view it would be extremely difficult to enforce a scheme for protecting payments made direct to foreign accommodation suppliers. It seems to it to be a reasonable compromise to cover facilities that are supplied through a link on an airline's website and to protect the flight element of truly independent packages.
- 7.10 The CAA recognises that the reasons of principle for differentiating between air travel and surface travel are not strong, and it does not discount the arguments that favoured the simplicity of a single all-embracing protection system. In this aspect however the CAA concluded that the price of simplicity might be higher than could be justified by the benefits to be obtained. Journeys by surface travel are generally lower in price and booked without long advance notice, and repatriation tends either not to be an issue at all or a less serious one, with alternatives available. Further, travel is provided by a very large range of providers who are often small firms, and regulation of this sector would be relatively expensive: this would both be a burden on the firms themselves and increase the unit costs of regulation across the industry. Firms providing surface-based packages are already regulated by the Package Travel Regulations, and although the protection provided may not have been perfect in some instances (for example, there have been reported cases of insufficiently policed trust accounts), it has been generally adequate. Finally, the surface sector differs from the scheduled airline sector in that it is not subject to particular growth that might distort the proportion of holidays protected. The CAA doubts whether Government would be persuaded by the record in this sector that a step change in the scope of regulation is justified.

- 7.11 The CAA believes that, of the options available, its recommended option would best meet the objectives and principles it has set out. It would meet the expectations of customers, that have been demonstrated by the CAA's research and the responses to the consultation, for protection for the majority of holidays. It would provide greater simplicity, from the point of view of customers, through the wider coverage and it would benefit competition by removing a competitive distortion that exists at present in the air holiday market. It would also allow the current coverage, which without legislative change will deteriorate, to be preserved. It would be entirely consistent with the key principles of Better Regulation, particularly in terms of proportionality and targeting.
- 7.12 The CAA has considered separately the issues of the scope of protection and the mechanisms to provide it, and Section 9 below deals with the latter aspect. They are however linked to some extent, and it is clear that the proposed extension of scope depends on there also being a change in mechanisms to move away from (at least exclusive) dependence on bonding. This is partly because of the lack of bonding capacity to serve an expanded scope and partly because the legal framework (for example, the European Council Licensing Regulation, which sets out criteria for licensing airlines) would make it difficult to require bonds from all airlines.
- 7.13 As to how the legislative changes might be achieved, the CAA recognises that it would be greatly preferable for requirements to apply on at least a European-wide basis. It notes the points that were made by ABTA about the lack of alignment between the UK's legislation and the Package Travel Directive, and these can probably now be resolved only by a revision of the Directive. The CAA fears however that the timescales involved could be so long as to raise a significant risk of a major collapse in the interim, and it therefore believes that the UK should introduce its own legislation in the short term. It recognises that it might not be possible to pass even domestic legislation as quickly as would be desirable, and it has set out in the following section some proposals for the interim period.

8 Possible interim measures

- 8.1 The CAA recognises the possibility of some delay before its proposals could become law and, as it has noted, it believes the problem needs to be addressed urgently. It believes that there may be a possibility of achieving some progress in the interim on a voluntary basis. This would of course require the co-operation of the travel industry and airlines, but in view of the possibility of a collapse with serious adverse publicity for the industry, they may consider that it is in their interests to act in advance of legislation. Ideally, the voluntary measures would be adopted throughout Europe, and although the CAA recognises the practical obstacles here it suggests that a UK initiative might serve as a model for other EU states with similar issues.
- 8.2 As this paper has highlighted, there are two types of holiday and flight at issue: one is the quasi-package sold through linked websites, while the other is the flight that is genuinely bought on its own or with other facilities that are bought independently. Different interim solutions may be appropriate to these different categories.

- 8.3 Some airlines which responded to the CAA's draft advice have indicated that they see quasi-packages as in a different category from flights sold on their own, and that they would be prepared to cover the whole "package" by ATOL where a flight is sold in conjunction with other facilities, although there is currently no legal necessity to do so. In practical terms, this could work by implementing a switch from the airline's own website to that of an ATOL holder as soon as the customer attempts to book other items. In the CAA's view, this could go a long way to dealing with the problem that the public expects protection for packages but often does not get it at present.
- 8.4 For flights sold on their own, the solutions may be more varied. Repatriation remains a potentially difficult issue, and although some respondents stated that IATA arrangements would ensure that passengers were not stranded abroad, the CAA has not seen any evidence that there are reliable arrangements in force even for IATA airlines; indeed, the recent collapse of Duo suggested the reverse. In any event, many of the newer airlines are non-IATA. If comprehensive and reliable repatriation arrangements could be introduced by the airlines themselves, the problem might be substantially alleviated. It is possible that BAR UK (which represents the majority of the full service airlines serving the UK) and representatives of no-frills carriers might have a role in taking this forward.
- 8.5 If the above two measures were successfully put in place, the exposure to the public might be restricted to that in relation to advance bookings for flights sold on their own. As the CAA has already noted, it does not believe that a statutory requirement to disclose the absence of protection would be effective in dealing with this problem, but a standard message might be adopted by airlines to make the position clear and this might be combined with an offer of appropriate insurance. Airlines might also wish to explore whether travel insurance policies – which many people wrongly believe cover airline failure – might in reality be expanded to do so in more cases, and whether suitable policies might routinely be offered at the point of sale. It remains to be seen whether insurers are willing to take on additional exposure to airline failures but this possibility is at least worthy of exploration.
- 8.6 In parallel with the above, it might be possible to agree a code of conduct – covering both airlines and travel firms – on disclosure to customers of information about financial security. This would need to incorporate principles about the prominence with which information is to be displayed as well as the content of messages to be displayed.
- 8.7 The CAA would (if Government wishes) be willing to explore with airlines whether they are able and willing to put effective interim measures in place. If they are, an improvement for customers might be secured within a reasonably short period. The CAA does not regard voluntary action as an effective substitute for legislation: however, if these or other measures could be demonstrated to work well, the urgency for legislation would be reduced accordingly. Conversely, if there is no action or no effective change, the need for very early legislation will be critical.

9 Mechanisms to provide protection

9.1 The CAA drew attention in its consultation paper to the fact that a common fund might be a cheaper long term solution than bonding and to problems of bond availability, although it also acknowledged that the involvement of bond obligors provided another filter in relation to both finance and fitness. The current problems with bonds suggested however that there was a case for a common fund, and that case was supported by most of the travel industry. It is relevant to add that if the scope of the system was extended as proposed, it is extremely unlikely that current sources of bonds could service the expanded demand.

9.2 However, the issue is perhaps not as straightforward as some respondents suggested. As outlined in Section 5, without bonds the fund would have to be capable of dealing with a failure of one of the largest tour operators who currently provide bonds of up to £250 million, and expenditure at most times of the year would be significantly more than that. The figures would be higher if the system was designed to cover all payments, including those made by credit card. This would have various consequences:

- If the fund were set at a level to cover the failure of the largest single tour operator, it would be apparently extremely large for “normal” failures. Failures of the largest operators have historically happened only every 10-12 years, and the average spend over the last 17 years has been £9 million per year, with even that being heavily influenced by the £69 million cost of the ILG failure in 1991.
- At any reasonable contribution rate it would take a long time to build up a large enough reserve; the illustration in Section 5 indicates that a levy of around £2 per annum would build up a fund of about £560 million over five years.
- It is not clear how we would deal with the interim if a large failure happened before the fund was sufficient. Some contributors suggested that the Government might underwrite the fund as it does the Air Travel Trust: however, the scale would be much larger without bonds and this may be politically unacceptable. Borrowing might be possible but banks are increasingly risk averse and might ask for a Government guarantee; phasing out bonds might also be possible but this could create an expensive interim, even if insurers were willing to service a market without a future.

9.3 It was notable from the survey of mechanisms in other EU states that the most common approach was a combination of common fund and individual bank or insurance quasi-bonding instruments (though that might be partly because some were modelled on the UK) and there were no radical funding instruments identified. However, the shortcomings of the two main contenders – bonds and a common fund – may indicate that it is inappropriate simply to consider these as options but to explore whether other mechanisms are possible.

9.4 The CAA remains of the view that a common fund solution has attractions in terms of total costs and reducing the dependence on the market for individual bonds. Although bonds also have their merits in providing a partly market-based solution and a role in providing barriers against fraud and serious under-capitalisation, the CAA accepts that their relative inefficiency in terms of costs and benefits and their inconsistency of supply makes bonds an inadequate mechanism on their own on which to base a long-term protection solution.

9.5 However, the practical difficulties noted in relation to a fund may not be easily overcome, and the CAA suggests that the issue of mechanisms should be explored further. At least two possibilities appear suitable for further research:

- there might be a possibility of a mutual insurance instrument, with capacity constraints having less of an effect if the total annual cover required for the whole industry were less than at present. This might be the case if the cover were set to reflect the effects of a limited number of failures rather than a percentage of industry turnover.
- Banks might be willing to devise their own mechanisms that would meet the needs and be offered as part of a range of facilities, and this might particularly affect the larger firms. It is relevant to add however that the extent to which firms may opt out of a mutual scheme if they are able to make other arrangements will affect the viability and the attractiveness from an insurer's point of view of a mutual insurance solution.

The CAA will progress work on these and any other realistic options. The view which Government forms on the future of holiday protection will of course be an important factor in discussions in this area.

9.6 Neither of the courses outlined above would necessarily deal with all the disadvantages of an insurance instrument in terms of the lack of reliability of the overall market and the appetite for underwriting travel, and there would be a net cost reflecting insurers' risks and profits that would qualify the economic arguments at Section 5 of this paper. However, they and any other approaches between the common fund and that of entirely operator-specific arrangements may still be worth further thought.

9.7 The recommendation that airlines providing flights from the UK should be required to provide protection against their insolvency does not in the CAA's view depend on licensing, which it accepts might be difficult in view of the European Council Licensing Regulation and the UK's international obligations. If the mechanism for protection took the form of a fund or similar mutual arrangement, then contributions similar to Air Passenger Duty could be made without licensing. Although the CAA believes that in general a mutual arrangement should be protected by the filtering process of licensing and applying financial criteria, these could not apply in cases where the UK clearly does not have the power to refuse entry to the system. The interaction between mechanisms and scope does however require further study. For example, some respondents suggested that a contribution could be collected with tickets like Air Passenger Duty, and this has attractions: if it is accepted however that there is no need to provide protection where payment is made in arrears, there would need to be a mechanism for excluding such payments. That dimension does not at present arise with Air Passenger Duty and the CAA acknowledges that identifying sales to be excluded may not be easy.

9.8 An extended protection system would not necessarily imply that repatriation would be centrally organised on all occasions. Respondents to the consultation valued repatriation highly, but it would be necessary to distinguish between those air services where reasonable travel alternatives exist and those where they do not: customers may for example be quite capable of arranging their own return from Paris and claiming a refund subsequently, but it may be impossible for them to do so from Malaga in the peak season without significant delays and at high cost. It may not be easy to define in advance those routes on which repatriation would be organised, but there is in the CAA's view a case for focusing the resources of the system administrators where customer needs dictate.

10 Other issues

- 10.1 The CAA raised various other aspects in its consultation paper, including for example the role of financial regulation and how and where a new protection system might be managed. In its view these are necessarily subordinate to the principal issues of scope and mechanisms: for example, financial regulation may be more necessary in a system that includes an element of a mutual fund or insurance policy, and the case for moving the ATOL system out of the CAA might be stronger if its scope extended to surface transport.
- 10.2 There was general support for financial regulation, though its benefits were not usually analysed except by insurers and financial institutions who made clear that they placed reliance on a clear regulatory framework and the insistence on minimum financial criteria. The CAA's view is that there is likely to be a continuing need for these approaches to protect sources of funds, still more if insurers do not underwrite individual firms.
- 10.3 On the issue of where protection should be managed, there was some diversity of view; most respondents thought that the ATOL system could reasonably be expanded rather than replaced. Some respondents suggested, as they have done before, that an extended system would best be managed by an independent travel licensing authority, although the arguments set out for this did not appear to the CAA to be compelling. Unless the Government is inclined to include surface transport in a single statutory system, it has to be asked whether the cost of the change to re-position the system elsewhere can be justified.

11 Next steps

- 11.1 The CAA believes that the problems it has described are serious and need to be tackled urgently. It seeks the Government's agreement in principle to an extension of the scope of financial protection as outlined in this paper. The CAA accepts that the costs and benefits of such an extension will need to be rigorously assessed in a Regulatory Impact Assessment, and that funding mechanisms will need to be defined in detail. However, the CAA's view is that the more detailed analysis should follow a Government commitment in principle to change, such commitment to be confirmed if the more detailed analysis supports, as we believe it will, the arguments in principle.
- 11.2 If the Government can give this commitment, the CAA sees three consequences that should flow:
- The UK should give strong support to European Commission initiatives to review whether current protection arrangements, particularly in relation to scheduled airline passengers, are adequate; and should press vigorously for an outcome that extends the current scope of European legislation in this respect.
 - The Government will need to make an assessment of the likelihood of appropriate EU legislation, and the timescale in which this might be achieved. Unless it is satisfied that both the substance and timing of EU legislation will meet the UK's needs, the Government should be prepared to introduce legislation in the UK to prevent further damage that may be done in the interim.

- The CAA recognises however that even UK legislation may take some time. In view of the urgency of the problem it recommends that Government should take early action to see whether voluntary interim measures, involving as a minimum all airlines serving the UK, can be put in place.

11.3 Depending on the initial conclusions reached by Government, the CAA envisages progressing several further workstreams:

- developing options and proposals for funding structures and mechanisms;
- preparation of a full Regulatory Impact Assessment; and
- detailed planning and discussions in preparation for the proposed interim measures.

Annex: Summary of principal changes made to the draft advice published in March 2004

Section 1 – Introduction

The introduction has been amended to set out more fully the consultation process; to draw out the two key respects in which the CAA's conclusions have changed; and to comment on changes to the document more generally.

Section 2 – Summary of conclusions

The recommendations have been amended to refer to international flights only, and to extend the definition of a "package" to include sales through linked websites. Further amendments emphasise the need for action at EU level and also to refer to proposed interim measures.

Section 3 – Principal issues highlighted in the consultation process so far

New paragraphs have been added at 3.2 and 3.4 to explain more fully why the current legislation is now unable to meet the purposes for which it was designed, and to refer to the separate categories of quasi packages bought through linked websites and independently booked holidays.

Section 4 – Substance of responses to the consultation

This section has been amended to include, at a high level, comments made in response to the CAA's draft advice. In particular, paragraph 4.4 summarises the points made by the main travel industry associations; 4.5 refers to consumer input; and 4.7 to 4.10 refer to points made by airlines at the later stage.

Section 5 – The scope of protection: principles

This section has been significantly reordered, though some parts of it have not been changed substantially. The paragraphs under the headings "Competition Aspects" and "Simplicity" are not changed in any significant respect.

The scope issues are dealt with first and are similar to the corresponding section in the last draft, though the figures in table 1 have been updated, with corresponding amendments in paragraph 5.5, and are no longer provisional. The section on demand is also substantially the same, though paragraph 5.11 refers to some repatriation issues that were emphasised by the failure of Duo Airlines.

The economic arguments in paragraphs 5.13 to 5.20 are new and replace the previous section headed "Cost Dimensions". The paragraphs under "Disclosure and Information" at 5.31 to 5.34 set out more fully the difficulties in relying on customers being aware of their rights, and the European and international context is also set out rather more fully at 5.35 to 5.36. The new paragraph 5.37 relates the CAA's proposals to key Better Regulation principles.

Section 6 – The scope of protection: options

The principal changes in this section are to boxes 4 and 5 in the first table to introduce the concept that a protection system might extend to quasi-packages where airlines sell flights and facilitate the sale of accommodation to be used in conjunction with flights. The second table introduces a third possible restriction at c), where protection would apply to international travel only.

Section 7 – The CAA's recommendations on the scope of protection

This section has been amended to reiterate the historical context (paragraph 7.2) and to emphasise the two categories of traveller who now have no financial protection. It summarises the economic argument at 7.5. Paragraph 7.8 is new and explains the reasoning behind its suggestion that domestic travel might be excluded. The final paragraph, 7.13, is new and refers to how changes might be achieved.

Section 8 – Possible interim measures

This section is new.

Section 9 – Mechanisms to provide protection

This section is largely unchanged, but paragraph 9.2 (previously 8.2) has been amended in the light of further work on costs.

Section 10 – Other issues

This section is unchanged.

Section 11 – Next steps

Paragraph 11.2 has been amended by the addition of a reference to voluntary interim measures.