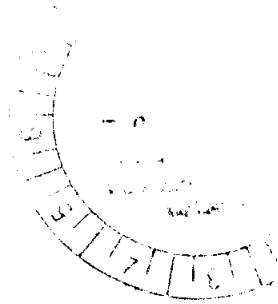




BARA

BOARD OF AIRLINE
REPRESENTATIVES
OF AUSTRALIA INC



Our Ref.: Let.1684

4 September 2004

Ms Margaret Arblaster
General Manager, Transport and Prices Oversight Division
Australian Competition and Consumer Commission
GPO Box 520 J
Melbourne VIC 3001

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Dear Ms *Margaret* Arblaster

RE: AIRSERVICES AUSTRALIA - DRAFT PRICING NOTIFICATION

The Board of Airline Representatives of Australia (BARA) was a party to the consultations undertaken by Airservices Australia (AsA) in relation to its proposed longer term approach to pricing airways services. BARA was a participant in both the Steering Committee and the Working Group established for the consultative process to identify and resolve issues surrounding the development of price paths for AsA services.

BARA's comments on the draft pricing proposal submitted by AsA at the conclusion of its industry consultations are set out below. The comments address the matters identified in the *Issues Paper* released by the Australian Competition and Consumer Commission following receipt of the draft notification.

Long term pricing plan

As a result of the consultations undertaken by AsA and its airline customers, it was agreed that a five year pricing agreement based upon the building blocks methodology favoured by the ACCC should be adopted. Airline representatives involved in the consultations were reasonably confident that such an approach would:

- (a) provide an incentive for AsA to reduce costs and improve efficiencies over time, and
- (b) limit the possibility and magnitude of possible future price shocks.

Given the inherent difficulty of assessing the current efficiency of AsA's cost structure, the discipline imposed by a longer term pricing arrangement gave airline representatives some comfort that there will be an ongoing trend for AsA's costs to be more efficiently incurred in future.

Consultation processes

BARA was pleased with the consultative approach adopted by AsA to provide airlines with details of its existing operations, the costs of the various services provided to customers and

planned future infrastructure development. The level of transparency adopted by AsA was welcomed by airlines. AsA also noted and acted on airline recommendations in relation to future capital investments, possible rationalisation of services delivered and areas for potential efficiency improvements.

BARA believes that the consultation process adopted by AsA provides a model for the ongoing commercial relationship between AsA and its airline customers. If AsA continues to pursue these types of discussions with airlines, BARA is confident that there will be continuous improvement of air traffic control services.

Risk sharing arrangements

BARA accepts that the risk sharing arrangements proposed by AsA are reasonable. Possible pricing adjustments to account for large variations in activity levels and capital expenditures and changes to government regulation provide an acceptable balance between AsA and its airline customers in terms of financial outcomes. In this regard BARA is cognisant of the need for AsA to be funded to a level sufficient to ensure its service levels are maintained and aviation safety is not compromised.

Operating costs

The Steering Committee and the Working Group devoted considerable attention to the efficiency of AsA's operating costs. It is difficult for third parties to be fully satisfied that the AsA cost structure is truly efficient. However, airline representatives generally accepted that:

- (a) substantial increases in operating costs contained in the AsA pricing proposal did not necessarily reflect a fundamental problem with AsA efficiency,
- (b) some cost increases were the direct result of increases in service levels, either requested by customers or imposed by government regulation, and
- (c) AsA had provided all relevant financial and operational information requested by airline representatives as part of the consultative process.

As noted above, airline representatives also took some comfort from the fact that the discipline imposed by a longer term pricing arrangement should result in an ongoing trend for AsA's costs to be more efficiently incurred in future. AsA also undertook to airline representatives that it would engage in ongoing consultations with the industry about its cost base.

Capital expenditure

BARA was pleased with the consultations undertaken by AsA in relation to its proposed capital expenditure program. The estimated costs of the capital projects are acceptable and the proposed capital expenditure monitoring process is welcomed by airlines.

The technology in place for air traffic management is evolving rapidly. BARA, therefore, accepted that AsA should be given a reasonable amount of flexibility in specifying its likely future capital program. The nature of the technology deployed also can be subject to CASA regulation and approval. Under these circumstances the AsA capital program represents a "best guess", but it is a "best guess" that has been fully explored with the industry. If one technology becomes obsolete, it is likely that investment in another technology will take its place. The risk sharing arrangements in place for capital expenditures also act as a safety net for airline customers in terms of effects on AsA's price path for airways services.

There is, however, one proposed capital project that is not supported by airline representatives. Whilst understanding and supporting AsA's objective in improving safety, BARA nevertheless questions the need for expenditure on ground movement radars at Brisbane and Melbourne airports. BARA is advised that the same level of safety could be achieved by using more efficient methods that are currently available, such as Automatic Dependent Surveillance Broadcast (ADS-B) technology.

Asset base

In the AsA consultative process BARA acknowledged that AsA had been requested to value its assets as part of the pricing proposal exercise. BARA also acknowledged that the ACCC favours to adoption of the optimised depreciated replacement cost methodology for asset valuation. Recognising the foregoing, BARA is willing to accept:

- (a) the value of the AsA asset base contained in the draft notification, and
- (b) the revaluation of assets that previously had a zero written down book value.

However, BARA's acceptance of the AsA asset valuation contained in the draft notification is subject to the following:

- (a) acceptance by AsA that its asset base for pricing purposes is now defined and further revaluations for pricing purposes will not be required,
- (b) AsA abiding by its commitment to update its asset base according to actual capital expenditures, depreciation and asset disposals, and
- (c) AsA providing the above information to airline customers on an annual basis.

The above considerations are a particularly important aspect of the airlines' acceptance of the AsA pricing proposal. They are fundamental to ensuring that any large and unpredictable increases to airlines' cost structures are either avoided or minimised.

Rate of return

There are two matters of interest in considering the rate of return contained in the AsA draft price notification:

- (a) the consultation process included obtaining independent advice about the appropriate WACC to be adopted by AsA, but the terms of reference provided to the independent adviser specified that the proposed WACC should be consistent with previous ACCC decisions, and
- (b) AsA has proposed to phase in its rate of return to its full WACC over the term of the proposed price path.

In relation to (a) above, BARA believes that empirical evidence suggests that the asset betas adopted by the ACCC for regulated industries are overly generous. BARA believes that the asset beta included in the AsA WACC is, consequently, too high. However, in the interests of reaching an agreement with AsA BARA is willing to accept the proposed WACC.

In relation to (b) above, AsA accepted phasing in its rate of return in response to concerns by the major airlines that they were continuing to subsidise regional and GA airports via the network pricing proposal included in the draft notification. However, the reduction in AsA revenue associated with the reduced WACC is substantially lower than the losses that the major airlines incur from cross-subsidising other users. Major airlines continue to fund the users of regional and GA towers though increased charges for terminal navigation and enroute navigation

services. Nevertheless, airline representatives are pleased that the reduction in the AsA WACC sets a precedent for recognising the cost burden of cross-subsidies on major RPT airlines.

Activity forecasts

The activity forecasts adopted in the draft notification reflect estimates provided by IATA. BARA accepts the activity forecasts and the assumptions underlying them.

Structure of prices

BARA's comments on the matters raised in the ACCC *Issues Paper* regarding proposed AsA pricing structure are set out below.

(i) Method of allocation of indirect costs

BARA does not agree with the AsA proposal to re-allocate indirect costs on a capacity to pay basis. BARA agrees with the view adopted by the ACCC in its previous decisions that AsA's activity based costing methodology for cost allocation is correct. The end result of the change in the AsA methodology for allocating indirect costs is merely to disguise the cross subsidy of regional and GA users by major airlines.

BARA maintains there is no economic justification for the proposed AsA methodology.

(ii) "Basin" approach to terminal navigation charges

BARA does not support the AsA proposed "basin" approach to terminal navigation charges. The AsA approach represents a return to network pricing, which is inherently inefficient. Further, AsA has argued that an "interdependency" exists between city basin airports, but it has failed to provide any evidence to support such a proposition.

The "basin" approach:

- (a) undermines and unwinds the efficiency and transparency benefits obtained with the recent adoption by AsA of location specific pricing, and
- (b) encourages unwarranted expenditure and cost inefficiency at the subsidised locations.

It is BARA's strongly held view that location specific pricing is the appropriate methodology for charging for terminal navigation services so that users make decisions on the consumption of services based on the actual costs of service delivery. If the government should decide that a subsidy for regional terminal navigation services is justified, then the subsidy should be completely transparent and funded from consolidated revenue.

(iii) Timing of price increases

BARA believes that the cross subsidisations contained in the AsA pricing structure should end immediately. However, given that AsA has proposed:

- (a) a phasing in of its full rate of return, and
- (b) an ongoing 10% increase in terminal navigation charges at regional and GA towers so as to progressively reduce cross subsidies

BARA is willing to accept the proposed timing of price increases. The AsA proposal over time delivers an incentive for users of regional and GA towers to review the need for the level of service provided at those locations.

(iv) Pricing across services and user groups

As noted above, BARA supports location specific pricing by AsA service and location. Any under funding of services as a result of this approach should be funded by direct subsidies by the government. Of course, such subsidies should not be recouped simply by an increase in the aviation fuel levy.

In the absence of government support for transparent direct subsidies, BARA commends AsA for its proposal to fund at least part of the under pricing at regional and GA airports through a reduced WACC. This aspect of the AsA proposal establishes an important precedent.

BARA also acknowledges that the amount of the cross subsidy will reduce over time as a result of:

- (a) the increase in prices at regional and GA airports by 10% per annum from 2005-06 onwards,
- (b) the review, in consultation with industry, of the need for towers with low traffic levels (accounting for relevant regulatory and safety considerations), and
- (c) review of the need for non-essential enroute navigation aids (again accounting for relevant regulatory and safety considerations).

It is unlikely, however, that the above actions will remove all under pricing by 2008-09. The issue of cross subsidies will need to be addressed again at the conclusion of the proposed five year agreement. BARA suggests that, at that time, AsA should give serious consideration to funding all remaining under pricing by a reduced rate of return.

Impact on users

The AsA pricing proposal will result in different impacts on different users. The relative impacts will depend on the mix of AsA services consumed by AsA customers. The general outcome, however, is that users of AsA services at regional and GA airports continue to benefit from significant cross subsidies at the expense of the major RPT airlines.

There are, however, some positive across-the-board impacts that result from the AsA pricing proposal. Firstly, the pricing proposal gives certainty to all users about the services to be delivered and the prices to be charged for the term of the agreement. Secondly, the pricing proposal gives greater confidence to all AsA customers that AsA will seek to pursue operating efficiencies and manage its costs efficiently. Thirdly, the pricing proposal delivers a capital expenditure program over time that has been agreed with industry and reflects the requirements of AsA's major customers. Finally, the pricing proposal provides a mechanism for risk sharing between AsA and its customers through the pricing review provisions.

Conclusion

BARA advises that it is willing to support the proposed AsA pricing agreement. The agreement does not address all the concerns about AsA pricing that BARA has raised in previous submissions. However, the draft notification represents good progress by AsA in addressing many of those concerns.

BARA acknowledges that the pricing proposal:

- (a) delivers financial transparency,
- (b) commits to continued consultations between AsA and its customers,
- (c) provides greater comfort to AsA customers in relation to AsA's operating efficiencies,
- (d) delivers defined service standards,
- (e) establishes an agreed capital expenditure program, and
- (f) accepts the principle of risk sharing between AsA and its customers.

Please contact the undersigned if you have any questions in relation to the above comments.

Yours sincerely

A handwritten signature in black ink, appearing to read "Warren Bennett". The signature is written in a cursive style with a large, prominent initial 'W'.

Warren Bennett
Executive Director