



Issues Paper

Airservices Australia

Draft Price Notification

August 2004

Purpose of this issues paper

On 12 August 2004, the Australian Competition and Consumer Commission (ACCC) received a draft price notification from Airservices Australia (Airservices). The notification is available on the ACCC's website at www.accc.gov.au. The ACCC now seeks submissions on the proposal from users and other interested parties.

Background and outline of proposal

Airservices is the monopoly provider of aviation en route navigation, terminal navigation and rescue and fire fighting (ARFF) services in Australia. Under section 95X of the *Trade Practices Act 1974*, these services are declared to be notified services and Airservices a declared person in relation to the supply of these services.¹ The relevant declaration, Declaration 66,² is available on the ACCC's website. As a declared entity, Airservices is required to notify the ACCC of proposed increases to the prices of these declared services. The ACCC is then responsible for assessing the proposed price increases, and may either not object to the proposed increases (in effect approving the proposed prices), or not object to increases lower than the proposed prices (in effect approving specified lower prices).

In June 2004, the ACCC made no objection to Airservices maintaining its current prices until 31 December 2004.³ This decision was made to allow further time for Airservices to develop its longer-term pricing proposal in consultation with its customers and to provide adequate time for ACCC consideration of the pricing proposal.

Airservices is proposing a long-term pricing arrangement that will apply for the next five years (2004/5 – 2008/9). Airservices' draft price notification proposes new prices commencing in October 2004 and its press release of 12 August 2004⁴ states 'Subject to the time taken by ACCC to complete its review we anticipate introducing our new prices around the end of October 2004.'

The draft price notification covers all of Airservices' declared services, at each location throughout Australia. The prices proposed vary across both service and location and in each year, but are generally characterised by increases in the prices of terminal navigation and ARFF services, and decreases in the prices charged for enroute navigation services. A summary of the weighted average price changes is contained in Airservices' draft notification and is shown in the following table. The details of the proposed pricing arrangements are set out in Airservices' draft notification.

¹ These services, and Airservices as a provider of these services, were originally declared under s 21 of the *Prices Surveillance Act 1983*. On 1 March 2004, the Prices Surveillance Act was repealed and replaced by Part VIIA of the *Trade Practices Act 1974*.

² As varied by *Variation of Declaration No. 66*, dated 11 August 1995.

³ In the absence of this decision, Airservices' declared prices would have reverted to their June 2002 levels from 1 July 2004. The ACCC's decision is available from the ACCC's website at <http://www.accc.gov.au>.

⁴ Available on Airservices' website, at www.airservicesaustralia.com

Table 1 Proposed annualised price changes

Regulated Services	2004/05	2005/06	2006/07	2007/08	2008/09	Total
Terminal Navigation	15.5%	3.0%	2.1%	1.2%	0.5%	23.5%
ARFF	15.9%	6.3%	3.8%	3.2%	1.6%	34.1%
Enroute	-5.2%	-1.1%	-2.5%	-0.9%	-0.9%	-10.3%
Weighted Average <i>[Incl. new services]</i>	4.0% <i>[5.2%]</i>	1.3%	0.0%	0.4%	0.0%	5.8%

While Airservices has proposed particular prices over the five-year period, its proposal contains three scenarios under which it may seek to review these prices within the five-year period. These circumstances are where:

- new regulatory or customer requirements change services levels which result in a net change in costs
- actual capital expenditure varies substantially from the levels agreed
- activity levels deviate materially from the levels contained in the proposal

Airservices also states in its draft notification that it will continue to review pricing structures over the course of the pricing arrangement.

Airservices states that its draft notification is the outcome of an extensive consultation process which began in August 2003 involving representatives from the industry. It established an industry steering committee and a smaller working group in developing its pricing plan. Airservices also consulted with representatives of regional and general aviation operators throughout June and July 2004 and has amended its original pricing plan in response to representations it received.

The ACCC's assessment process

In assessing Airservices' current pricing proposal, the ACCC will consult with users and other interested parties. The proposed process is outlined in the table below.

Table 2 Indicative timeline for ACCC assessment process

Date	Action
12 August 2004	ACCC receives Airservices' draft pricing proposal
17 August 2004	ACCC releases issues paper
14 September 2004	Closing date for submissions on the issues paper
October 2004	ACCC releases draft decision and calls for comments
October/November 2004	Closing date for comments on the draft decision
November 2004	ACCC releases final decision

The ACCC's role and statutory criteria

The ACCC is responsible for assessing price notifications related to increases in the prices charged for en route navigation, terminal navigation and ARFF services in Australia.

The approach taken by the ACCC in assessing price notifications is outlined in the *Draft statement of regulatory approach to price notifications* (the draft statement).⁶ This document is available on the ACCC's website.

In considering the price notification provided by Airservices the ACCC is required by s 95G(7) of the Trade Practices Act to have particular regard to the following:

- the need to maintain investment and employment, including the influence of profitability on investment and employment
- the need to discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices
- the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals

The draft statement sets out the ACCC's interpretation of these criteria. The ACCC invites comment on the application of these criteria to the current price notification.

Issues for comment

The ACCC welcomes comment on issues relevant to the ACCC's consideration of the pricing proposal. The ACCC has also identified a number of specific issues for comment. It would be useful for the ACCC if parties could, if possible, structure submissions around the identified issues. However, this list of issues is not exhaustive, and as noted above, comment on other relevant matters is also welcomed.

Long-term pricing plan

In previous ACCC decisions on Airservices' pricing proposals, the ACCC has favoured Airservices developing a longer-term pricing arrangement, in consultation with its users, in preference to a short-term rate of return approach to seeking price increases.

Airservices has chosen to submit a five-year pricing proposal, and has submitted its proposed pricing based on the application of a 'building block' model.

Consultation processes

Airservices has devised its pricing proposal in consultation with users, including through its steering committee and working group and through separate consultations with regional and general aviation users.

⁶ Readers of the draft statement should note that Part VIIA of the Trade Practices Act has replaced the Prices Surveillance Act and that references to the Prices Surveillance Act should be read as referring to the relevant section of the Trade Practices Act. The substantive content of the draft statement remains applicable to the new legislation.

The ACCC seeks comment on the effectiveness of Airservices' consultation processes in its development of the draft price notification and the extent to which the proposal is supported by you or your organisation.

Risk sharing arrangements

A number of risks are relevant in establishing long-term pricing arrangements and it is generally desirable for such risks to be borne by the party to the agreement which is best able (ie most efficient) to manage such risks. Risks inherent in a long-term pricing arrangement include:

- 'market' risks, including changes in activity from forecast and other exogenous shocks
- risk of cost over-runs
- technological risks, such as the timing of uptake of a new technology
- the risk of changes to government regulation

The ACCC seeks comment on the appropriateness of the risk sharing arrangements embodied in the proposal, in particular relating to the activity trigger mechanism, the approach taken to changes in Airservices' capital expenditure program and changes in regulation.

Operating costs

Airservices' estimated operating costs are set out in its draft notification. These estimates include increases in estimated staff costs totalling 24.6 per cent over the five-year period and increases in supplier costs totalling 22.2 per cent over the same period.

The ACCC seeks comment on the efficiency with which Airservices provides its services, including:

- the level of estimated operating costs reflected in Airservices' proposal
- Airservices' incentives to, and effectiveness in, containing and reducing costs

Capital expenditure

Airservices is proposing capital expenditure of \$542 million over the five-year period, a break-down of which is contained in its draft notification. Airservices has also explained its approach to continue to develop this capital expenditure program and make 'adjustments ... at the end of the pricing cycle, or if a significant change occurs during the life of the plan.'

The ACCC seeks comment on the efficiency of Airservices' proposed capital expenditure program, including:

- the appropriateness of the capital projects included within the proposal
- the level of the estimated costs of the capital expenditure proposed
- the approach taken to determining the capital expenditure program over the period covered by the pricing proposal

Asset base

Airservices' proposed prices incorporate a return on its assets. The value of assets used is based on a report by Hymans Asset Management, an extract of which is

attached to its draft notification. The result of this asset valuation was an increase in the value of assets of \$41.7 million (14%) as at September 2003.

The ACCC seeks comment on:

- the efficiency of Airservices' asset base
- the appropriateness of Airservices' new values for its asset base
- the appropriateness of revaluing assets which previously had a zero written down book value

Rate of return

Airservices' proposal includes a return on capital in the form of a 'nominal vanilla WACC' of 9.75%, based on a recommendation from PriceWaterhouseCoopers.⁸ However, while Airservices proposes this rate to apply in 2008/9, it is proposing 'to target a lower WACC in 2004/5 and to progressively increase this to 9.75% in 2008/9'. Airservices states that this approach will 'act as a formal incentive to seek additional productivity efficiencies in order to achieve a normal return during this period.' The rates of return proposed are shown in the table below.

Table 3 Proposed rates of 'nominal vanilla' WACC

	2004/05	2005/06	2006/07	2007/08	2008/09
WACC Target (Full)	9.75%	9.75%	9.75%	9.75%	9.75%
Increasing WACC Target	6.00%	7.25%	8.50%	9.25%	9.75%

The ACCC seeks comment on:

- the appropriateness of Airservices' proposed rate of return on capital
- the proposal to apply a transition to a higher WACC by different rates of return in each year
- the extent to which the proposal will act as an incentive on Airservices to achieve increases in productivity

Activity forecasts

Activity levels at each location are applied in Airservices' proposal to translate the proposed revenue levels into individual prices. Airservices has based its forecasts for activity growth over the five years of the proposal on the activity estimates provided by IATA⁹. The growth rates proposed are shown in the table below.

⁸ A copy of the PWC Report is available on the ACCC website at www.accc.gov.au.

⁹ A copy of the IATA Report is available on the ACCC website at www.accc.gov.au.

Table 4 Forecast activity growth rates

	2004/05	2005/06	2006/07	2007/08	2008/09
Enroute	4.2%	5.2%	4.6%	4.3%	4.0%
Major Airports	5.6%	4.7%	3.8%	3.7%	3.1%
Regional Airports	3.0%	2.6%	2.1%	1.5%	1.3%
General Aviation Airports	1.0%	2.0%	2.0%	2.0%	1.8%
Weighted Average	4.7%	4.9%	4.1%	3.9%	4.7%

The ACCC seeks comment on the reasonableness of Airservices' activity estimates.

Structure of prices

Airservices' pricing proposal reflects a continuation of location-specific pricing, in which the prices of each of its regulated services vary by location. However, the current proposal reflects a number of changes in the manner by which Airservices has structured its pricing.

Method of allocation of indirect costs

Airservices states in its draft notification that 'in past proposals Airservices adopted a conventional activity based costing approach to distribute joint or common costs to service lines.' However, in this proposal, it 'has adjusted its allocation approach toward one that takes into account users' capacity to pay' and has allocated 'distributed costs' based on 'the chargeable units underpinning the service (ie. tonnes landed).'

The ACCC seeks comment on whether the proposed method of cost allocation is appropriate.

'Basin' approach to terminal navigation charges

Airservices has proposed a 'basin' approach to charging for its terminal navigation services, which spreads the cost of airports co-located within the major capital city 'basins'. Airservices states that it has 'targeted a revenue level for each metropolitan city basin as a whole in lieu of individual airport targets'. Under its proposal, 'the prices at the secondary locations will increase by 16.8% in the first year and 10% per annum for the following four years.'

Airservices states that the basin charging approach is in recognition of the interdependencies that exist in the operation of such airports, 'where the existence of the secondary location has a significant positive impact on reducing the congestion at the major basin airport'. Airservices also states that an increase in the number of light aircraft operating at major airports would impact on the operations of the major airport and that there are significant levels of shared resources in the management of airports within a common 'basin'.

The ACCC seeks comment on the appropriateness and efficiency of the application of a capital city 'basin' approach to charging for terminal navigation services.

Timing of price increases

In moving to Airservices' proposed structure of pricing and incorporating increases in forecast expenditure, Airservices has proposed a maximum annual increase in prices of 16.8% in the first year, followed by later year increases to a maximum of 10%.

The ACCC seeks comment on the appropriateness of the phasing in of proposed price increases stemming from both changes in the structure of charging and from projected cost (operating and capital) increases.

Pricing across services and user groups

Airservices states that its current system of prices involves cross subsidies between its various services and estimates that 'at current prices enroute is set to over-recover its costs by nearly \$22m, whereas terminal navigation and ARFF services will under-recover by more than \$60m.' It lists as one of the aims of its pricing as 'avoiding cross subsidising the costs of other services' and states that 'the impact of removing cross subsidies in service line prices is more significant' [than the overall price increase over the five-year period].

While Airservices states that the proposed prices will reduce cross-subsidisation between service lines, the precise details of this do not appear to be contained in the draft notification.

The ACCC seeks comment on the appropriate method of achieving Airservices' stated aim of avoiding cross-subsidies and on the appropriateness of the levels of cross-subsidies between services and between user groups contained in the pricing proposal.

More generally, the ACCC seeks comment on:

- whether the proposed prices provide appropriate incentives for Airservices to provide services at particular locations
- whether the proposed prices provide appropriate incentives for users of Airservices' services to provide services at particular locations

Impact on users

The ACCC seeks comments on the likely impact of the proposed prices on the users of airports and air traffic control services. In particular, the ACCC seeks comment on the likely impact on:

- demand for air travel
- airline scheduling decisions
- providers of other aviation services
- airfares

Submissions and contact details

Written submissions must be received by **close of business on 14 September 2004**.

The ACCC endeavours to make the consultation and decision process as transparent as possible. For this reason, submissions made to the ACCC will be made publicly available on the ACCC's website. Any interested parties who wish to provide

information on a confidential basis should clearly identify the specific parts of their submissions that they wish to remain confidential and the reasons for claiming confidentiality.

The ACCC will also consider hearing oral submissions from interested parties. Should any party wish to make an oral submission, please contact the persons named below as soon as possible.

Submissions should be forwarded by email to:

margaret.arblaster@accc.gov.au, and
lyn.camilleri@accc.gov.au

Alternatively, submissions can be made by mail to:

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If you have any questions about this issues paper, please call Lyn Camilleri on (03) 9290 1973 or Rod Middleton on (03) 9290 1981.

17 August 2004