QANTAS

QANTAS AIRWAYS LIMITED
ABN 16 009 661 901

SUBMISSION

TO THE

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

AIRSERVICES AUSTRALIA'S FIVE YEAR PRICING PROPOSAL

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Executive Summary

Qantas Airways Limited (Qantas) is a substantial user of the services provided by Airservices Australia (AsA). Accordingly, Qantas and its customers (passengers and those transporting freight) are directly affected by the prices charged by AsA.

AsA has clearly improved the quality and effectiveness of its consultation process in developing a longer-term price path. All interested parties have had the opportunity to participate and AsA has provided all the information requested by users. While the Australian Consumer and Competition Commission was not directly involved in the consultation process, its previous directions guided the development of the pricing agreement.

Qantas has given careful consideration to the pricing agreement proposed by AsA and is concerned that the pricing proposal results in Qantas' international and core domestic services paying many additional millions of dollars each year compared to a 'first best' outcome of full location specific pricing. In addition, Qantas does not endorse some of the propositions put forward by AsA in its Draft Notification, in particular, 'basin' city pricing and the re-allocation of indirect costs on a 'capacity to pay' basis.

Despite these concerns, Qantas is prepared to support the pricing agreement. The agreement addresses many of the previous concerns raised by Qantas. In particular, the pricing agreement provides for:

- financial transparency and commitments to continued consultation with users;
- confidence over operating efficiency;
- defined service standards;
- an agreed capital expenditure program;
- mechanisms to trigger a review of pricing, if necessary, over the next five years; and
- a continuation of location specific pricing. AsA has also accepted part of the burden of under pricing at regional/general aviation locations.

AsA has proposed a workable solution that is a considerable improvement over previous 'year on year' pricing arrangements. The consultation process serves as a model for other air navigation providers. The acceptance by AsA of a lower rate of return to fund part of the under-pricing of some services establishes an important precedent in recognising the burden of cross-subsidies on major regular public transport (RPT) operators. However, Qantas remains concerned that the reduced rate of return reverts to a full costing over the period of the agreement without a permanent solution to the lack of subsidy to cover the shortfall in revenues associated with the under-pricing of some services.

Consultation over pricing started in August 2003. It is now time for AsA and industry to finalise pricing and focus on achieving the operational benefits that should flow from the agreed capital expenditure program. This includes ensuring the delivery of new services and technologies and reviewing the need for some existing infrastructure.

1 Introduction

Under the direction of the Australian Consumer and Competition Commission (the Commission),[1] Airservices Australia (AsA) has sought to implement a longer-term approach to pricing based around adequate consultation with users. The Steering Committee (SC) and Working Group (WG) established to progress issues have followed the advice and directions contained in the Commission's previous assessment of pricing by AsA.[2]

The key elements of the pricing agreement proposed by AsA are:

- increases in overall prices to fund new services, capital expenditure and return on assets;
- gradual transition to reduce the current levels of cross-subsidy between terminal navigation, aviation rescue and fire fighting (ARFF) and enroute services;
- partial funding of the under-pricing at regional and general aviation (GA) locations through a lower rate of return in the first four years of the agreement;
- an agreed capital expenditure program based on anticipated technological developments with commitments to further consultation and refinement; and
- agreed trigger mechanisms to initiate discussions between AsA and users over activity levels, capital spend and changes to regulatory arrangements.

Through the SC and WG, Qantas has devoted considerable resources to the consultation process. In contrast to previous price notifications by AsA, Qantas is now in a position to offer a considered response to key issues due to the provision of all requested information from AsA.

2 Assessment of Issues

Qantas has structured this submission on the basis of the Commission's *Issues Paper.* Accordingly, the issues discussed below are:

- consultation processes;
- risk sharing arrangements;
- operating costs;
- capital expenditure;
- asset base;
- rate of return (weighted average cost of capital (WACC));
- activity forecasts;
- structure of prices; and
- impact on users.

Each of these issues is discussed below.

2.1 Consultation processes

Qantas is satisfied with the quality of the consultation undertaken by AsA in developing its five year pricing agreement. The process included:

- sharing of all requested financial and operational information;

[1] Australian Competition and Consumer Commission (ACCC), Decision. Airservices Australia Proposed Price Increase, June 2003.
[2] ACCC, June 2003.

- presentations from various technical and operating departments within AsA, in which important issues and cost drivers were explained;
- robust and constructive discussion over key issues such as service levels, capital expenditure, operating costs, rate of return and activity forecasts; and
- a willingness for all parties to try to reach an acceptable outcome on key operating and financial issues.

Qantas also considers that AsA has benefited from the consultation process. Financial transparency has encouraged greater accountability over costs and the delivery of projects. As a result, a more sound and robust platform is now in place to ensure continual consultation and the progressive improvement of air traffic management services.

Notwithstanding the improvement in AsA's consultation process there are still a number of unresolved issues which Qantas remains concerned about.

2.2 Risk Sharing Arrangement

Qantas supports the risk sharing arrangements proposed by AsA. The arrangements seek to strike an acceptable balance between AsA and users over key financial outcomes.

- Activity trigger mechanism: Qantas considers it important that AsA should receive a level of funding sufficient for it to deliver its services in a safe and efficient manner. The 5% on a cumulative basis activity trigger is regarded as consistent with this objective. Importantly, the parties have agreed to meet and discuss the situation should activity volumes differ significantly from that forecast.

- Capital expenditure: As discussed later in this submission, it is not feasible to plan the entire proposed capital expenditure program with the level of confidence that can be achieved in other industries. Ultimately, any shortfall or excess spending on capital can be incorporated into the next five year pricing agreement. The proposed review mechanism allows AsA to adjust pricing before the end of 2008-09 in the event of large variations in the level of capital spend, hence promoting smoother prices over a longer period of time.

- Changes to government regulation: The pricing agreement does not attempt to capture the potential cost impacts of changes to government regulation in current prices, for example, changes to ICAO requirements and the security environment.

2.3 Operating costs

Consideration of AsA's operating costs was the most difficult issue for the SC and WG to address in developing the five year pricing agreement. The WG spent considerable time understanding and evaluating AsA cost efficiency.

The increases in costs noted by the Commission (24.6% for staff and 22.2% for suppliers over five years) may appear high, but this is not an accurate reflection of the underlying level of efficiency. In particular, some cost increases are necessary to support planned increases in service levels. These are due to either regulatory change (new fire stations and increases in ARFF categories) or the service expectations of users, such as user-preferred routes and flexible use airspace.

It will always be difficult for any outside party to satisfy itself completely that there are no further efficiencies to be extracted from AsA's proposed operating costs. However, it is recognised that AsA has provided all financial and operational data requested by users as part of the consultation process. In addition, Qantas continues to stress that AsA should have sufficient funding to maintain service levels and implement safety initiatives.

Qantas considers that by developing a known price path, AsA will have strong incentives to manage its costs efficiently. The pricing agreement rewards AsA for efficient management of its costs. With defined service levels and commitments to consultation there are adequate avenues for AsA to demonstrate that it has not sought higher profits by reducing service standards.

On the basis that AsA is committing to a known price path and continued consultation with industry, Qantas does not object to the level of operating expenditure proposed by AsA.

2.4 Capital Expenditure

Qantas supports the collaborative process undertaken by AsA in developing the capital expenditure program. The program is consistent with the Air Traffic Management Strategic Plan and incorporates the views of users as part of the consultation process.

While each project in the capital expenditure program will benefit users to a differing degree, Qantas considers that the overall program achieves a reasonable spread of benefits across all users. For example:

- the 'HF frequency modernisation' project and 'VHF Radio Upgrade' are two projects that yield benefits to all users;
- the 'National Aeronautical Information Processing System (NAIPS) Enhancement' project will primarily benefit non regular passenger transport (RPT) operators; and
- the 'ADS-B Upper Airspace' project will bring specific benefits to ADS-B users while non-ADS-B users will benefit from the "Navaid Replacement Project".

While supporting the majority of projects in the program, Qantas endorses the SC's reservations in relation to the need for a surface guidance movement system at Brisbane and Melbourne airports. Qantas is not convinced that more efficient alternatives have been explored. However, it is noted that AsA has sought to engage Qantas in the consultation process in examining the requirement for the surface movement guidance system.

Subject to the planned reviews of capital expenditure, Qantas does not object to the estimated cost of the capital projects.

Qantas endorses the cohesive approach to capital expenditure monitoring proposed by AsA. Air navigation technology is a rapidly evolving environment. It is likely that the choice of technology to provide certain services will change over the next five years. In addition, the timing of expenditure and deployment is at times subject to Civil Aviation Safety Authority (CASA) approval.

If AsA incorporated only those projects that had a high degree of certainty, it would be necessary to seek continual price adjustments when projects outside that scope are endorsed by industry. Qantas does not propose the inclusion of a 'Necessary New Investment' (NNI) type framework into the pricing agreement. In effect, to provide certainty in pricing, Qantas recognises that the proposed capital program is indicative only and will need to be updated through time as technological and regulatory issues are progressed. As discussed earlier, Qantas supports the risk sharing arrangements over capital expenditure.

2.5 Asset base

As stated in previous submissions, Qantas does not support the application of asset valuation methodologies such as depreciated optimised replacement cost (DORC) in setting prices. However, it is recognised that AsA was requested to value its assets as part of the consultation process.

As expected, the valuation of AsA's assets proved extremely difficult, particularly given the subjective nature of the process and lack of suitable comparable studies in overseas countries.

The efficiency and valuation of AsA's existing asset base needs to be considered in the context of the large associated capital expenditure program. In a number of cases it is planned to replace existing assets with new technologies to provide the same or an enhanced level of service. However, this does mean that the value of the new technology should be used as part of the 'optimisation' process. This is because the ability to introduce the new technology is not assured. Final approval from regulatory bodies, including CASA is usually required.

Where an asset required major refurbishment, this is reflected in the valuation of the existing asset. This means that industry is not expected to 'pay twice' for the provision of existing assets.

In terms of re-valuing assets that previously had a zero written down book value, as a point of principle Qantas does not endorse the increase in value of any asset for pricing purposes as the industry has already paid for the investment in the asset.

Qantas continues to oppose the use of DORC valuations for pricing purposes. However,

- now that a Regulatory Asset Base (RAB) for pricing purposes is established, further re-valuations for pricing purposes are no longer necessary; and
- going forward, AsA will continue to track and update the RAB based on actual capital expenditure, depreciation and disposal of assets,

Qantas does not object to the value determined by the consultant being used for pricing purposes in this instance.

2.6 Rate of Return

In recognition of the difficulty in reaching consensus over an appropriate WACC, the SC agreed to seek external advice from an agreed independent party (PriceWaterhouseCoopers (PwC)). The terms of reference provided to PwC clearly specified that the proposed WACC should be consistent with previous decisions by the Commission.

Qantas continues to express concerns over the asset betas afforded by the Commission to regulated industries. Empirical evidence continues to indicate that the asset betas of listed companies (equity betas de-lever into asset betas) on the Australian Stock Exchange are far lower than those adopted by the Commission in its pricing decisions. However, the proposed WACC of 9.75% (asset beta 0.60) is regarded as consistent with previous determinations on WACCs by the Commission in its pricing decisions.

Qantas considers it appropriate that AsA also bears part of the burden of not adopting full location specific pricing. Optimally, all under-pricing would be funded through a reduced rate of return, excluding the $7million in direct subsidies provided for 2004-05. The proposed reduction in WACC does not fully cover the shortfall in revenues from under-pricing at many regional and GA locations. Part of the shortfall is still funded by major airlines through higher pricing for terminal navigation and enroute services. Notwithstanding this, the acceptance of a lower rate of return by AsA establishes an important precedent in recognising the burden of cross-subsidies on major RPT operators. However, the reduced rate of return reverts to a full costing over the period of the agreement without a permanent solution to the lack of subsidy to cover the shortfall in revenues associated with the under-pricing of some services.

The extent to which a reduction in WACC will encourage further increases in productivity by AsA is uncertain. The development of an agreed price path will act as the main incentive for

AsA to efficiently manage its costs. That said, there is little concern that the reduction in WACC will hamper the incentives for AsA to achieve productivity increases.

2.7 Activity Forecasts

Qantas does not object to the activity forecasts proposed by the International Air Transport Association (IATA).

2.8 Structure of Prices

Qantas offers the following comments on the various issues raised by the Commission in relation to AsA's proposed structure of prices.

Method of allocation of indirect costs

Qantas does not support the re-allocation of indirect costs on a 'capacity to pay basis'. The Commission has previously endorsed AsA's activity-based costing approach to cost allocation and Qantas considers activity-based costing as the correct method to allocate indirect costs.

The effect of the change is to simply 'hide' part of the cross-subsidy to regional/General Aviation (GA) users through unjustified cost shifting. This practice is not endorsed and means that users are shielded from an awareness of the actual cost of providing services at subsidised locations.

Qantas does not object to the prices proposed by AsA. However, it is considered appropriate for the Commission to direct AsA to reallocate its indirect on the basis of activity-based costing. This will ensure that the full level of subsidy provided to some users continues to remain transparent to industry.

'Basin' approach to terminal navigation charges

Qantas does not support the application of the capital city basin approach to charging for terminal navigation services. In its Draft Notification, AsA argues that "the concept is based on the inherent interdependency that exists between the operations of these (city basin) airports, where the existence of the secondary location has a significant positive impact on reducing the congestion at the major basin airport."[3] However, AsA has not provided any empirical evidence to support this proposition.

Qantas believes that in a scenario where a secondary airport closed (or aircraft were priced away), light aircraft operations would re-distribute to non-controlled aerodromes within the greater basin area. For example, within the Adelaide basin, if the Parafield aerodrome closed, light aircraft operations would be likely to shift to non-controlled aerodromes such as Murray Bridge.

AsA also argues that capital city basin pricing prevents inefficient outcomes at major airports where peak hour movements and slots would reduce by more than 10%.[4] This argument does not take into account the existing congestion management systems in place at major airports, designed to prevent such an outcome.

The capital city basin approach adopted by AsA continues a regime of cross subsidisation for the delivery of terminal navigation services. AsA has not supported the rationale for this approach with empirical evidence or detailed analysis. Qantas considers location specific pricing an appropriate mechanism to charge for terminal navigation services. This ensures that users make decisions based on the actual cost of providing services to them. Consistent

[3] Airservices Australia (AsA), Draft Price Notification, August 2004, p. 28.
[4] AsA, August 2004, p. 29

with the decision to re-allocate indirect costs on a 'capacity to pay basis', in Qantas' view, the 'basin' approach to terminal navigation is simply a form of cross-subsidy.

Timing of price increases

The timing of the proposed price increases is viewed as appropriate. As previously stated by the Commission,[5] there is flexibility for AsA to re-structure prices over time and this is reflected in AsA's pricing agreement.

Given that the Government has elected not to move to full location specific pricing at this point, the continual 10% increase in prices at regional/GA locations is considered appropriate. This will ensure that users continue to have a strong incentive to review the need for, and level of, service provided at such locations.

Pricing across services and user groups

AsA was given a difficult task in deciding upon the level of under-pricing at regional and GA locations and how this under-pricing would be funded. In particular:

- the Government's May 2004 Budget provided for a $7million subsidy in 2004-05 only;
- the Government stated that "...there was never any prospect of regional and general aviation airport service prices being set to merely reflect the costs identified in AsA's consultation documents"[6];
- major RPT airlines, including Qantas, support location specific pricing by service by location; and
- regional and GA stakeholders argued that full location specific pricing based on fully allocated costs was untenable, and would result in business closures and dysfunctional behaviour at smaller locations.

A 'first best' outcome for industry would be for any under-pricing by AsA to be funded through direct subsidies from the Government, assuming these subsidies were not simply recouped through an increase in the fuel excise. However, on the basis of statements made by the Government and the 2004 Budget, the 'first best' option does not appear available to AsA.

Qantas considers that AsA has established an important precedent in funding at least part of the under-pricing at regional/GA locations through a reduced WACC. In addition, the level of cross-subsidy should be reduced through time by:

- increasing prices at regional/GA locations by 10% from 2005-06 onwards;
- reviewing towers with low traffic levels, in conjunction with industry, to determine their ongoing need or service level requirements in accordance with relevant regulatory and safety considerations; and
- reviewing the need for non-essential enroute navigation aids in accordance with relevant regulatory and safety considerations.

These measures, however, are unlikely to eliminate all under-pricing by 2008-09. Many GA towers will still only be recovering a fraction of the cost of providing services at each location. As such, it will still be necessary for the Government, AsA and users to revisit this issue near the end of the proposed five year pricing agreement. It could be that by 2008-09 the level of under-pricing is reduced to a point where AsA could fund all under-pricing through a lower cost of funds and reduced return to the shareholder.

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[5] ACCC June 2003, p. 63.

[6] The Hon John Anderson MP, 'Anderson Welcomes Airservices Move on Prices' Press Release A90/2004, 12 August 2004.

Pricing structure

As contained in previous submissions to the Commission, Qantas considers that there is merit in reviewing AsA's current weight and distance-based charging structure. Suggested review criteria include:

- identification of the main cost drivers associated with different services; and
- consideration of different potential charging structures against a specified set of criteria, including:
  - alignment with cost drivers and beneficiaries,
  - practicality of implementation,
  - incentive effects for investment by both AsA and users, and
  - changes in the level of payments made by different sectors of the aviation community, such as Regular Public Transport (RPT) and General Aviation (GA).

It is acknowledged that there was not sufficient time available to explore this issue in adequate depth in developing the current pricing agreement. However, Qantas does consider that this issue should be addressed by industry with a proposal put to the Commission in due course.

Incentives to provide and use services

The proposed pricing agreement will generate appropriate incentives for AsA to provide services at particular locations. Underpinning the pricing agreement is the 'Service Delivery Baseline' that specifies the level of service to be provided at individual locations. AsA has also committed to further consultation over the capital expenditure program, to enable scrutiny over the delivery of agreed projects.

The pricing agreement will also produce appropriate incentives for users of AsA's services to provide services at particular locations. The gradual transition in pricing is consistent with previous direction by the Commission. Users are provided with ample notice of planned price changes and can adjust their consumption patterns accordingly.

2.9 Impact on Users

The five year pricing agreement gives certainty over the services provided and the prices charged. This compares to previous arrangements where AsA provided little indication of forward looking prices.

It is clear that the pricing agreement will have different impacts on users depending upon the mix of services they consume. The pricing agreement continues to provide considerable subsidies to regional/GA operators. As such, the impact on users needs to be considered in the context of the actual cost of providing the services versus what users are required to pay.

While Qantas does not endorse some of the propositions put forward by AsA in its Draft Notification, it is satisfied that the pricing agreement provides a sound platform for the provision and pricing of air traffic management and ARFF services over the next five years. The impact on users therefore includes both the proposed price increase and the benefits of a more stable price path and robust foundation for the provision and pricing of air traffic management and ARFF services.

3 Conclusion

AsA has clearly improved its consultation process in developing the five year pricing agreement. Although the Commission was not directly involved in the consultation process, its previous directions guided the development of the pricing agreement. Qantas is satisfied with the level of information provided by AsA in relation to this proposal.

While Qantas does not agree with all the propositions put forward by AsA in its Draft Notification, Qantas supports the proposed five year pricing agreement. This is because the pricing agreement provides for:

- financial transparency and commitments to continued consultation with users;
- confidence over operating efficiency and incentives for AsA to manage its costs efficiently;
- an agreed capital expenditure program;
- defined service standards;
- mechanisms to trigger a review of pricing, if necessary, over the next five years; and
- a continuation of location specific pricing. AsA is also required to share part of the burden of under pricing at regional/GA locations although this diminishes over time.

It will still be necessary to review and debate some of the underlying principles used to formulate this agreement. This includes the concept of 'basin' city pricing, the allocation of indirect costs, and funding the under-pricing of services at regional/GA locations. However, It is now time for AsA and industry to finalise pricing and focus on achieving the operational benefits that should flow from the agreed capital expenditure program. Qantas is confident that outstanding issues can be discussed and resolved during the term of the first pricing agreement.

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