Submission to Australian Competition and Consumer Commission review of Airservices Australia's proposed draft price notification

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This report contains 20 pages

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1 Executive Summary

On 12 August 2004, the ACCC received a draft price notification from Airservices Australia ('AsA'). AsA is proposing a long-term pricing arrangement that will apply for the next five years (2004/05 to 2008/09). AsA's draft price notification covers all of AsA's declared services, at each location throughout Australia. Subsequent to the draft notification, the ACCC released an issues paper that seeks submissions on the proposal from users and other interested parties. This submission from Virgin Blue is pursuant to the ACCC's issues paper.

This submission comments on both aspects of the proposed price path with which Virgin Blue is comfortable and aspects with which we have some concerns. In terms of the latter, Virgin Blue's most significant concerns relate to:

- The structure of prices, including the apparent cross-subsidisation in pricing across services and locations;
- The efficiency of AsA's operating costs;
- The allocation of costs between locations; and
- The Commonwealth Government's role in supporting regional air services.

Accordingly, while Virgin Blue is supportive of the approach AsA has adopted in developing its proposed price path – in particular the consultation process, it does support AsA's draft price notification but with some concerns detailed below.

More specifically, Virgin Blue's major concerns are that:

- Cross subsidisation across services and locations will place an unfair financial burden on Virgin Blue and therefore reduce allocative efficiency;
- It is not clear that AsA's proposed operating costs for the price path represents efficient (or even reasonable) costs in an overall sense. AsA was not able to provide sufficiently detailed information to justify the substantial increases in operating costs in some areas for the initial year of the price path. One area of particular concern to Virgin Blue is AsA's superannuation expense. In particular, as a publicly owned entity, AsA's superannuation arrangements are considered overly generous relative to a purely commercial organisation and above an efficient payment level;
- The financial burden of increased terminal navigation and ARFF charges is likely to be greater for Virgin Blue than Full Service carriers. This is because full-service carriers carry a higher proportion of price insensitive customers (such as business travellers) and are therefore in a better position to pass on price increases without losing customers;
- AsA's Draft Price Notification suggests that charging principles will be re-examined after the price path is resolved. Previously, some parties have expressed a preference for passenger based charging rather than weight based charging. Passenger based charges for air navigation charges are flawed, since they:

- Unduly penalise price sensitive aircraft (low cost carriers);
- Unduly penalise more efficient aircraft; and
- Do not make intuitive sense.

- AsA's community service obligation funding from the Commonwealth Government is to cease on 30 June 2005. The subsidy is implicitly funded from an excise on AVGAS on AVTUR and payable only by Domestic Airlines. Importantly, it is not clear from the Federal Government that the excise will be lowered to reflect the removal of the subsidy. Accordingly, it would appear untenable that domestic airlines be required to pay additional duty on fuel ostensibly to recover costs that are no longer being incurred by the Commonwealth Government. While Virgin Blue recognises that this issue is beyond the scope of the present review, we nevertheless consider this an appropriate forum to raise our concerns in relation to this issue.

In response to these concerns and our views on the efficacy of the review process, Virgin Blue suggests that:

- A similar consultation process is adopted for future price reviews of air navigation services;
- The cross-subsidisation inherent in AsA's proposed price path and cost allocation approach is removed. To the extent that certain user groups do not have the capacity to pay charges, AsA should either seek community service obligation funding (funded from consolidated revenue) or accept a lower rate of return in recognition of the fact that it is providing a public good;
- The present approach of allocating indirect costs on the basis of staff numbers be maintained;
- The ACCC review the efficiency of AsA's operating costs, and specifically, consider the appropriateness of AsA being completely reimbursed for its superannuation arrangements;
- In reviewing the appropriateness of the cross-subsidisation in AsA's proposed price path, the ACCC considers that Virgin Blue is currently paying an unduly high rate of excise on AVGAS and AVTUR to subsidise regional and general aviation ('GA') airport tower services.

2 Background

2.1 Nature of review

Airservices Australia ('AsA') is the monopoly provider of aviation enroute navigation, terminal navigation and rescue and fire fighting ('ARFF') services in Australia. Under section 95X of the *Trade Practices Act*, these services are declared to be notified services and AsA a declared entity in relation to the supply of these services. As a declared entity, AsA is required to notify the Australian Competition and Consumer Commission ('ACCC') of proposed increases to the prices of these declared services. The ACCC is then responsible for assessing the proposed price increases.

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

On 12 August 2004, the ACCC received a draft price notification from AsA. AsA is proposing a long-term pricing arrangement that will apply for the next five years (2004/05 to 2008/09). AsA's draft price notification covers all of AsA's declared services, at each location throughout Australia.

Subsequent to the draft notification, the ACCC released an issues paper that seeks submissions on the proposal from users and other interested parties. This submission from Virgin Blue is pursuant to the ACCC's issues paper.

2.2 Consultative approach

AsA has undertaken an extensive consultation process in developing the proposed price path.

The process commenced in August 2003 when a cross-section of international, major domestic and regional airlines, along with industry associations, representatives from airports, the general aviation industry and the ACCC were invited to an inaugural consultation meeting. This meeting agreed the framework for developing the long term pricing arrangement and established an Industry Steering Committee to oversee the process. A smaller Working Group carrying out detailed analysis supported the Steering Committee.

The Steering Committee agreed to adopt the ACCC's building block model to assess allowable revenues, the use of independent consultants to determine key parameters and that five years was the appropriate length for the agreement. The Committee then progressively worked through the foundation elements that underpin the proposed pricing strategy, being:

- The target return on capital;
- The capital value of existing assets;
- The forecast costs by service and location;

- The proposed capital expenditure program; and

- The forecast activity levels.

It is understood that AsA also embarked on an extensive consultation process with the wider group during June and July 2004. This included mail outs to around 7,000 customers, airport meetings with major stakeholders, the establishment of a website with detailed service cost and investment information for each service and briefings to various industry and government representatives.

3 Airservices Australia's proposed approach

3.1 Outline of proposed approach

The key features of AsA's proposed price path are:

- A phasing in of higher prices, offsetting the impact of the expiration of the government subsidy for regional and GA tower services in June 2005;
- A revised cost allocation methodology for overhead and distributed costs based on aviation activity levels which takes account of users' capacity to pay; and
- The adoption of a 'basin' concept with respect to general aviation aerodromes situated in capital city locations.

These outcomes are supported by a lower weighted average cost of capital targeted by AsA, coupled with a slowing in the enroute price reduction.

The proposal seeks a weighted average price increase at the commencement of the new long term arrangement of 5.2% (or 2.8% in real terms). This increase includes 1.2% for new and 1.3% for upgraded ARFF services under recently mandated regulatory changes.

During the course of the next four years it is proposed that overall prices increase by a total of around 1.7%, or reduce in real terms. This would be accompanied by a rebalancing of pricing levels, with terminal navigation and ARFF service prices increasing, and enroute prices decreasing as shown in Table 3.1.

Table 3.1
AsA's 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	4.0%	1.3%	0.0%	0.4%	0.0%	5.8%

Source: Airservices Australia Draft Notification 2004

While AsA 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; and
- Activity levels deviate materially from the levels contained in the proposal.

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

3.2 Virgin Blue's key concerns

3.2.1 Introduction

This submission comments on both aspects of the proposed price path with which Virgin Blue is comfortable and aspects with which we have some concerns. In terms of the latter, Virgin Blue's most significant concerns relate to:

- The structure of prices, including the apparent cross-subsidisation in pricing across services and locations;
- The efficiency of AsA's operating costs;
- The allocation of costs between locations; and
- The Commonwealth Government's role in supporting regional air services.

For ease of readability, the submission is structured around the issues raised by the ACCC.

3.2.2 Consultation processes

Virgin Blue participated in both the Steering Committee and the Working Group. It should be emphasised that the consultation process worked effectively and we strongly recommend that a similar process be adopted for future air navigation services pricing matters. That said, it would appear that the consultation towards the end of the process was limited. In particular, Virgin Blue would have liked to have reviewed AsA's modelling outcomes in more detail and to this end requested various data from AsA in order to conduct our own detailed modelling. However, AsA did not to respond to the data request, on the basis that to do so was unnecessarily time consuming.

Recommendation: Virgin Blue suggests that a similar consultation process be adopted for future price reviews of air navigation services.

3.2.3 Risk sharing arrangements

Virgin Blue believes that the risk sharing arrangements embodied in AsA's proposed price path are reasonable. To provide the ACCC with some context, Virgin Blue accepted the revision triggers implicit in the proposed price path on the basis that it would reduce AsA's risk and therefore its required rate of return.

3.2.4 Long-term pricing plan

Virgin Blue believes that the length of AsA's proposed price path and the application of a building blocks methodology is appropriate on the basis that it should:

- Provide an incentive for AsA to reduce costs and increase efficiency; and

- Reduce the possibility and extent of price shocks to the cost structure of Virgin Blue.

In relation to the former, the adoption of a long term pricing model would provide greater assurance to Virgin Blue that AsA's costs will be efficiently incurred in the future. It will also ensure that AsA's management provides careful consideration to the long-term benefits of any capital investment.

In relation to the latter, as a low cost airline, Virgin Blue has an interest in ensuring that any unpredictable increases to its cost structure are either avoided or minimised. A longer term pricing path should lead to more stable prices over time, as prices would not be subject to short-run fluctuations. In addition, a long term pricing model would create greater certainty in relation to Virgin Blue's planning and forecasting, particularly in relation to the addition of capacity and/or frequency on existing routes and the commencement of flights on new routes. A long term pricing model will permit Virgin Blue to predict in advance, with considerable accuracy, the costs it is likely to incur in relation to ARFF, enroute and terminal navigation charges over the medium to long term.

Such certainty is particularly necessary where Virgin Blue is planning to commence operations on new routes, as new routes require Virgin Blue to make substantial upfront investments in assets with substantial sunk costs before operations commence (such as leasing of additional aircraft).

3.2.5 Capital expenditure

With one exception (outlined below), Virgin Blue believes that the capital expenditure embodied in AsA's proposed price path is reasonable.

Virgin Blue believes that the proposed expenditure on ground movement radars in Brisbane and Melbourne is not necessary. Virgin Blue understands and supports AsA's moves to improve safety. However, it would appear 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. Following our discussions with AsA, Virgin Blue understood that this item was going to be removed from the capital expenditure list. It was not until Virgin Blue examined AsA's Draft Price Notification and supporting material, that we were made aware of its inclusion.

In relation to the remaining proposed capital expenditure items, Virgin Blue makes the following comments:

- It is noted that some of the projects will result in reductions in operating costs and improvements in safety;
- The Working Group was provided with the opportunity to examine AsA's proposed capital expenditure and was satisfied that the cost estimates were reasonable; and
- Virgin Blue is very supportive of the approach used in determining the capital expenditure program over the period covered by the pricing proposal.

In relation to the last of these points, Virgin Blue would like to emphasise that safety issues were a principal driver in accepting AsA's capital expenditure program. Many of the items such as new fire trucks and refits to control towers are primarily safety related and safety was of paramount concern to Virgin Blue in agreeing to the capital expenditure items.

3.2.6 Asset base

Virgin Blue is willing to accept:

- The quantum of AsA's asset base; and
- The approach to revalue assets, which previously had a zero written down book value.

In relation to the former, Virgin Blue would like to highlight that, in the spirit of completing the review process within a reasonable time, we accepted various valuation simplifications that may have skewed the results more favourably towards AsA. By way of example, rather than value each control tower individually, Hymans valued only one control tower and applied this valuation across all control towers. The same approach was also adopted for valuing fire trucks.

In relation to the latter, while it is dubious for a monopoly service provider to receive a return on capital items where they have fully recovered costs, Virgin Blue is willing to accept their inclusion in the asset base in the spirit of reaching an overall reasonable agreement with AsA.

3.2.7 Rate of return

Virgin Blue notes that AsA is proposing to phase in its rate of return to its full WACC over the period of the proposed price path.

To provide the ACCC with some context, AsA phasing in its rate of return was in response to concerns from the major airlines that AsA was continuing to (inequitably) subsidise regional and GA airports. Virgin Blue notes however, that the reduction in revenue associated with the reduced WACC is substantially lower than the losses that major airlines are incurring from cross-subsidising other users.

Virgin Blue was provided with the opportunity to comment on AsA's proposed WACC early in the consultation process. Virgin Blue believes that the debt margin and asset beta implicit in the WACC is generous (albeit marginally) towards AsA, but was willing to accept the proposed WACC in the spirit of reaching an agreement with AsA.

3.2.8 Activity forecasts

AsA's forecast activity growth rates are outlined in the following table.

Table 3.2
AsA's forecast activity growth rates

Regulated services	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%**

Source: Airservices Australia Draft Notification 2004

The forecasts are largely based on estimates provided by IATA. Virgin Blue believes that both the forecast activity growth and assumptions underlying the forecasts are reasonable.

3.2.9 Structure of prices and pricing across services and user groups

AsA moved to "location specific" pricing from network pricing in 1997/98. This change was designed to improve the efficiency of its price structure, as prices would better reflect the cost of providing terminal navigation and ARFF services. AsA's pricing proposal reflects a continuation of this approach.

Virgin Blue is supportive of location based pricing. Of concern is that AsA's pricing proposal is not genuinely location specific and does not go far enough in that there is still cross-subsidisation occurring between some airports in the same geographic region (this issue is addressed in the next section). While this is disappointing, Virgin Blue notes that the stated intention of AsA is to eventually remove cross-subsidies.

AsA 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)."

As noted in the ACCC's issues paper, while AsA 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. Virgin Blue is of the view that there should be **no** cross-subsidisation in the price path.

Cross-subsidies occur when one group of users pay for more than the costs of the services they receive, and the surplus is used to offset the cost of services provided to other users. It is axiomatic that cross-subsidies generally reduce allocative efficiency. Those who pay the subsidy may restrict their use of the product, reducing desirable consumption that would have taken place if products were appropriately priced. Conversely, those who receive a subsidy may be encouraged to use too much of the product. There may also be adverse 'flow-on' effects where the services cross-subsidised are inputs to other activities. These concerns are particularly pertinent to airline travel since it is a derived demand[1].

In addition, the New Zealand Commerce Commission has noted that there are two major concerns flowing from cross-subsidisation in the context of aeronautical pricing[2]:

- If a supplier charged a price lower than the incremental costs of supply, its revenues would not cover its cost. If, at the same time, the supplier is still cost recovering over all, this suggests that the consumers of one product are supporting the consumers of another product. This does not send appropriate signals for resource allocation and use. It may also be perceived as unfair by consumers; and

- If a supplier charged a price above the stand-alone cost of supply, it would imply over-recovery. Once again, inappropriate signals for resource allocation and use are created. In addition, if the concept of stand-alone costs makes no allowance for the economies of scope that can be gained from providing several products together, and a monopolist charges for each product up to its notional stand-alone costs, with no adjustments to reflect economies of scope, it would also overrecover.

International Civil Aviation Organization ('ICAO') Policies on Charges for Airports and Air Navigation Services ('the Policies') contain recommendations and conclusions resulting from ICAO's continuing study of charges in relation to the economic situation of airports and air navigation services provided for international civil aviation. The Policies also take into account the recommendations made in this field by the Conference on the Economics of Airports and Air Navigation Services held in Montreal from 19 to 28 June 2000.

It is instructive to note that the Policies state that where, "*any preferential charges, special rebates, or other kinds of reduction in charges normally payable in respect of air navigation charges are extended to particular categories of users, governments should ensure, so far as practicable, that any resultant under-recovery of costs properly allocable to the users concerned is not shouldered onto other users.*[3]"

To the extent that certain user groups do not have the capacity to pay charges, other users should not be required to make up the shortfall. Alternative options would be for the Commonwealth Government to provide community service obligation funding (from consolidated revenue rather than increased taxation on the airline industry) or alternatively, AsA accept a lower rate of return in recognition of the fact that it is providing a public good.

Recommendation: Virgin Blue suggests that the cross-subsidisation inherent in AsA's proposed price path be removed. To the extent that certain user groups do not have the capacity to pay charges, AsA should either seek community service obligation funding (funded from consolidated revenue) or accept a lower rate of return in recognition of the fact that it is providing a public good.

[1] That is, people undertake airline travel in order to consume other goods and services.
[2] Final Report: Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports, August 2002.
[3] ICAO's Policies on Charges for Airports and Air Navigation Services, Sixth Edition 2001.

3.2.10 Method of allocation of indirect costs and basin approach to terminal navigation charges

AsA's draft notification highlights that in past proposals, it has adopted a conventional activity based costing approach to distribute joint or common costs to service lines. In relation to distributed costs, Virgin Blue understands that the primary allocator was the number of staff in each port.

Under this proposal, AsA indicates that it has adjusted its allocation approach toward one that takes into account users' capacity to pay. The draft notification highlights that distributed costs have been allocated within each service based on the chargeable units underpinning the service (ie tonnes landed). As a result of this change, a proportionately higher level of these costs will be recovered from Sydney, Melbourne and Brisbane users – routes where Virgin Blue primarily operates.

It is worth noting that ICAO recommends that the allocation of the costs of air navigation services among aeronautical users be carried out in a manner equitable to all users, regardless of size or capacity to pay. The proportions of cost attributable to international civil aviation and other utilisation of the facilities and services should be determined in such a way as to ensure that no users are burdened with costs not properly allocable to them according to sound accounting principles[4].

The tonnage of aviation traffic would appear to have a negligible relationship with AsA's expenditure on overheads and therefore the proposed approach is not based on "sound accounting principles"[5]. Accordingly, Virgin Blue considers that there is no economic justification for the proposed approach and that to the extent that equity issues are material, they should be accounted for by means other than arbitrarily adjusting cost allocation mechanisms[6].

The number of staff at a port would appear to have a reasonable nexus with overhead costs. In the absence of AsA identifying a more meaningful allocator, Virgin Blue suggests that the past and present approach to allocating indirect costs be maintained.

Recommendation: Virgin Blue suggests that present approach of allocating indirect costs on the basis of staff numbers be maintained.

[4] Ibid.
[5] Ibid.

[6] As noted previously, alternative options would be for the Commonwealth Government to provide community service obligation funding (funded from consolidated revenue) or alternatively, AsA accept a lower rate of return in recognition of the fact that it is providing a public good.

3.2.11 Timing of price increases

Virgin Blue's preference would be to remove the cross-subsidisation between enroute and other services immediately. Nevertheless, on the basis that AsA is proposing a phased in rate of return and in the spirit of resolving this issue, Virgin Blue is willing to accept the proposed timing of price increases.

3.2.12 Operating costs

Virgin Blue is satisfied that the efficiencies flowing from the proposed capital expenditure program are reflected in operating costs. However, Virgin Blue is not satisfied that AsA's proposed operating costs for the price path represent efficient (or even reasonable) costs in an overall sense. AsA was not able to provide sufficiently detailed information to justify the substantial increases in operating costs in some areas for the initial year of the price path. Given AsA's legacy as a Government Controlled Corporation, Virgin Blue considers it appropriate for the ACCC to thoroughly examine AsA's allowable operating costs.

One area of particular concern to Virgin Blue is AsA's superannuation expense. In particular, as a publicly owned entity, AsA's superannuation arrangements are considered overly generous relative to a purely commercial organisation and above an efficient payment level. It is understood that many of AsA's employees contribute to a defined benefit fund[7], which guarantees certain levels of entitlements and exposes the employer (and implicitly AsA's customers) to increased financial risk.

On this basis, Virgin Blue sought further information from AsA on its superannuation arrangements. AsA advised that their employees contribute to four separate superannuation schemes, which are outlined in the table below.

Details of AsA's superannuation schemes	
Scheme	**Type of scheme**
Commonwealth Super Scheme	Defined benefits
AvSuper	Defined benefits
Public Super Scheme	Defined benefits
AvSuper Accumulation	Accumulation[8]
Source: Verbal description from ASA on 27 February 2004	

Information provided by AsA to Virgin Blue suggests that oncosts (which primarily consist of superannuation) are forecast to increase from $40.6 million in 2003/04 to $59.5 million in 2008/09. This confirms that superannuation is a material expense item and an essential consideration in the context of the reasonableness of AsA's operating costs.

[7] In a defined benefit fund, benefits are based on a formula. They are called defined benefits because they are calculated – or defined – using a formula. The formula is usually based on length of membership, rates of contribution and salary. In a defined benefit fund the employer bears the investment risk.

[8] An accumulation fund operates in the same way as a bank account. Benefits are determined by the contributions paid by the member or on behalf of the member, for instance a rollover amount or an amount paid by an employer. Investment earnings, less any fees and charges are added to the contributions, negative earnings are deducted. In an accumulation fund the employee bears the investment risk.

It is understood that superannuation costs for the price path are made on the basis of actuarial advice and past investment returns. This might overestimate superannuation costs since returns in recent years have been unduly low.

Virgin Blue outlines an example for the ACCC consider the community service obligation funding provided by Queensland Transport (acting as the regulator) to Brisbane City Council for the provision of bus services in the Brisbane region as a good example of a regulated entity only receiving compensation for "efficient" superannuation costs. In this case, Queensland Transport does not fund "legacy" costs for items such as employer superannuation contributions over and above the minimum requirement and Brisbane City Council does not recover the shortfall from prices to end users. This approach shows precedent direction from a regulator with regard to legacy costs associated with a regulated entity's former government department status, such as unduly generous superannuation arrangements. That is, these legacy costs are neither recovered from:

- Customers; nor
- Specific CSO payments from the regulator.

Recommendation: Virgin Blue suggests that the ACCC review the efficiency of AsA's operating costs, and specifically, consider the appropriateness of AsA being completely reimbursed for its superannuation arrangements.

3.2.13 Impact on users

Virgin Blue notes that the financial burden of increased terminal navigation and ARFF charges is likely to be greater for it than for any full cost carrier.

Passengers have varying price elasticities of demand. Some passengers may have very low price elasticity of demand (such as business travellers) and others may have high price elasticity of demand (such as leisure travellers). Low fare carriers such as Virgin Blue generally have a higher proportion of high elasticity passengers compared with "full service" carriers such as Qantas which, through a higher cost structure, offer additional services for price inelastic travellers such as business travellers (eg business class seating and business clubs at airports). Further, when low fare carriers review the feasibility of particular routes that are being serviced by full service airlines, they generally allow for an overall increase in the number of passengers on the route following their entry on the basis that the lower prices they offer stimulates demand by attracting those price elastic passengers further along the demand curve who would not otherwise have travelled.

Therefore, when airlines are forced to pass on increased charges for air navigation services, the resultant fall in demand will be highest among the price elastic (sensitive) travellers, and there will be comparatively little fall in demand among price inelastic travellers, and this unequal fall in demand will impact more severely on low fare carriers than on other carriers. Therefore, low fare carriers such as Virgin Blue will suffer greater detriment than other carriers from this increase in costs.

3.2.14 Service Level Agreement

Virgin Blue has reviewed and been part of the development of the Air Traffic Management Strategic Plan which forms the service level agreement between Airservices Australia and its users. We believe that this document outlines sufficient moves in efficiency, safety and cost of the services that Airservices Australia provides.

3.2.15 Requirement for Provision of Services

Currently CASA has strict requirements to Airservices Australia as to when certain services are required at certain airports.

An example where this has become an issue is the recent upgrading of services in Maroochydore airport. As the airport has just breached the 300,000 passengers per annum threshold Airservices Australia is required to provide Rescue and Fire fighting services at that airport at great cost to the users of that airport. Virgin Blue would suggest as an interim measure the local fire services be able to provide the services at this airport instead of having dedicated airport fire services. This would allow time to see if the level of growth in that particular port is sustained. We believe this interim measure would maintain the same level of safety and security that currently is maintained. Also to take into account the hard and fast rules for increasing the category for airport's rescue and fire fighting. For an airport to be upgraded in category an increase the scheduled flights aircraft size irrespective of the number of flights. And the time frame in downgrading the airport due to decrease in services takes far too long.

Virgin Blue understands that these requirements are in place to ensure that Australia is consistent with the ICAO requirements. Some of the issues we face in Australia with the vast number of airports and the spread of our population around the country are issues that are unique to Australia. A deviation from these standards may be warranted with the relevant interim measures in place to ensure sufficient safety and security are in place.

The fact that some of these Tower and Rescue & Fire fighting services are in place in some smaller regional towns is making it very costly in providing any operations within these airports.

Recommendation: Virgin Blue suggests to CASA that a review on the requirements for Rescue & Fire fighting and Tower services is some smaller regional airports.

3.2.16 Basis of charging

AsA's Draft Price Notification suggests that charging principles will be re-examined after the price path is resolved. Previously, some parties have expressed a preference for passenger based charging rather than weight based charging. Virgin Blue would like to use this submission as an opportunity to reiterate our issues with passenger based charges. We believe that:

- Passenger based charges are less efficient than weight based charges;
- Passenger based charges are not as widely used as weight based charges;
- Passenger based charges unduly penalise price sensitive aircraft;
- Passenger based charges unduly penalise more efficient aircraft; and
- Passenger based charges do not make intuitive sense.

Each of these shortcomings is briefly described below.

3.2.16.1 Passenger based charges are less efficient than weight based charges

The Productivity Commission has noted that by, "requiring a payment for products supplied, users will better recognise the costs of the resources involved and gain an incentive to adjust their consumption in line with their willingness to pay.[9]"

The issue therefore, is to develop a charging mechanism that:

- Reflects the costs that users are imposing on AsA; and
- Reflects the willingness of **end** consumers to pay.

In terms of the former, developing a cost reflective structure would most likely involve fixed per plane charges that are independent of size (however defined). This is not likely to be acceptable on the basis that many (smaller) users would not have the capacity to pay and Virgin Blue is certainly not advocating this approach.

In terms of the latter, since customers of low cost carriers (such as Virgin Blue) are generally **more** price sensitive (and therefore have a **lower** willingness to pay) compared to customers of fulls service carriers, it could be argued that a charging approach that impacts disproportionately on low cost carriers should be avoided.

[9] Productivity Commission: Final Report on Cost Recovery by Government Agencies, 2001.

3.2.16.2 Passenger based charges are not as widely used as weight based charges

Weight based charges for air navigation services are a standard pricing methodology worldwide (it is noted that the application varies, in terms of whether or not fixed multiples, square root with and without steps etc.). We believe this is a reflection of the accepted wisdom in pricing according to cost of resources.

3.2.16.3 Passenger based charges unduly penalise price sensitive aircraft

Price sensitive aircraft are typically more reliant on maintaining high load factors. Under a passenger based charging system, the cost of providing marginal seats is more expensive, since charges are directly proportional to passenger numbers (rather than fixed on the basis of the weight of the plane). This unduly disadvantages more price sensitive aircraft such as low cost airlines and regional and GA operators.

3.2.16.4 Passenger based charges unduly penalise more efficient aircraft

Passenger based charges unduly penalise more efficient aircraft in that it would not encourage airlines to carry the maximum number of passengers for the weight of the aircraft. Virgin Blue believes that weight-based charges encourage airlines to use the lightest and fewest aircraft sufficient to meet passenger demand, and to configure aircraft to carry the maximum number of passengers for the weight of the aircraft. This results in the following efficiency effects:

- Promotion of efficiency in aircraft and fuel costs;
- Reduction in the level of emissions;
- Reduction in the level of noise pollution;
- More efficient use of limited slot positions; and
- Reduction in the impact on runway facilities.

3.2.16.5 Passenger based charges do not make intuitive sense

The size/weight of a plane influences the required level of ARFF capacity at an airport. The number of passengers on a plane does not. Under a passenger based charging system, a light aircraft carrying 10 passengers would be charged more than a jumbo carrying no passengers. However unlikely this scenario is, it demonstrates the fact that the AsA passenger-based approach is inequitable and fundamentally counter-intuitive.

Recommendation: Virgin Blue suggests that the ACCC state in its draft decision that AsA should not levy charges on a per passenger basis.

3.2.17 Commonwealth Government's role in supporting regional air services

It is understood that when AsA first implemented location specific pricing, charges at some GA airports would have had to increase up to 300% if full cost pricing was adopted[10]. An increase in charges of this nature would have severely impacted on aviation services and training facilities in regional Australia. Accordingly, the Commonwealth Government provides an annual subsidy to AsA on the basis that prices be capped in certain areas. The subsidy is funded by an increase in the excise and customs duties on AVGAS and AVTUR. These duties also fund the operations of the Civil Aviation Safety Authority ('CASA'). Virgin Blue believes that the amount collected from the excise significantly exceeds the subsidies paid to both organisations.

While CASA will continue to receive ongoing funding from this source, the subsidy will no longer be provided to AsA from July 2005. It is not clear that the excise will be reduced to reflect this. Accordingly, it would appear untenable that airlines be required to pay additional duty on fuel ostensibly to recover costs that are no longer being incurred by the Commonwealth Government.

With the recent upward trend in fuel prices, this issue takes on increased significance. Accordingly, irrespective of how this price review is resolved, there would appear to be a considerable need to provide airlines with at least some relief from high fuel prices.

Recommendation: Virgin Blue suggests that in reviewing the appropriateness of the cross-subsidisation in AsA's proposed price path, the ACCC considers that Virgin Blue is currently paying an unduly high rate of excise on AVGAS and AVTUR to subsidise regional and GA airport tower services.

[10] http://www.pc.gov.au/inquiry/costrecovery/subs/sub075a6.pdf

4 Recommendations

While Virgin Blue is supportive of the approach AsA has adopted in developing its proposed price path, it does not fully support AsA's draft price notification.

Accordingly, Virgin Blue suggests that:

- A similar consultation process is adopted for future price reviews of air navigation services;
- The cross-subsidisation inherent in AsA's proposed price path and cost allocation approach be removed. To the extent that certain user groups do not have the capacity to pay charges, AsA should either seek community service obligation funding (funded from consolidated revenue) or accept a lower rate of return in recognition of the fact that it is providing a public good;
- The ACCC review the efficiency of AsA's operating costs, and specifically, consider the appropriateness of AsA being completely reimbursed for its superannuation arrangements;
- The ACCC notes that the financial burden of increased terminal navigation and ARFF charges is likely to be greater for Virgin Blue than for full service carriers;
- The ACCC recommend that AsA should not levy charges on a per passenger basis; and
- In reviewing the appropriateness of the cross-subsidisation in AsA's proposed price path, the ACCC considers that Virgin Blue is currently paying an unduly high rate of excise on AVGAS and AVTUR to subsidise regional and GA airport tower services.