Australian
Competition &
Consumer
Commission

Preliminary View

Airservices Australia

Draft price notification

November 2004

Contents

Abbreviations and glossary of terms

ABC	activity-based costing approach, used to allocate costs to particular services
ACCC	Australian Competition and Consumer Commission
the Act	*Trade Practices Act 1974*
ADF	Australian Defence Force
ADG	Airport Development Group Pty Ltd
ADSB	Automatic Dependent Surveillance Broadcast
Airservices	Airservices Australia
AOPA	Aircraft Owners and Pilots Association
ARFF	aviation rescue and fire-fighting
AS Act	*Air Services Act 1995*
ASTRA	Australian Strategic Air Traffic Management Group
ATC	Air Traffic Control(ler)
ATS	Air Traffic Services
BARA	Board of Airline Representatives of Australia Inc.
BA	British Airways
BT	Business Transformation
BTRE AVSTATS	Bureau of Transport and Regional Services Aviation Statistics and Analysis
CAC Act	*Commonwealth Authorities and Companies Act 1997*
Cairns PA	Cairns Port Authority

CAPM	Capital Asset Pricing Model
capex	capital expenditure
CASA	Civil Aviation Safety Authority
common costs	costs of shared inputs used in the production of several outputs where the input proportions can be varied at the discretion of the enterprise, so that it is possible, in principle, to trace them to individual services
CPI	consumer price index
DBF	Defined Benefits Fund
DORC	depreciated optimised replacement cost
DPIWA	Department for Planning and Infrastructure Government of Western Australia
en route	aviation en route navigation
fixed costs	costs which do not vary with changes in the level of output, stemming from indivisibilities in supply, so that the same level of equipment or facilities accommodates, at the same quality of services, a wide range of output.
GA	General Aviation
GAAP	General Aviation Aerodrome Procedures
GAM	General Aviation Maintenance Pty Ltd
GNSS	Global Navigation Satellite System
Hymans	Hymans Asset Management
IATA	International Air Transport Association
ICAO	International Civil Aviation Organization

incremental costs	the change in total costs due to the production of a small discrete increase in the level of one output (see also marginal cost); when applied in the context of a specific service, the change in total costs due to the production in that service (or which are directly associated with that service)
indirect costs	those costs which are not directly attributable to an activity and are often referred to as overhead costs
ISAS	International Society of Aeromedical Services
ISC	Industry Steering Committee
ILS	Instrument Landing System
Jandakot Airport CC	Jandakot Airport Chamber of Commerce
Mackay PA	Mackay Port Authority
marginal cost	the increase in total cost associated with an increase in one unit of output
Maroochy SC	Maroochy Shire Council
MTOW	maximum take-off weight
NATS	National Air Traffic Services; the provider of ATC services in the United Kingdom
opex	operating and maintenance expenditure
PC	Productivity Commission
PwC	Pricewaterhouse Coopers
RAAA	Regional Aviation Association of Australia
Rockhampton CC	Rockhampton City Council

RFDS	Royal Flying Doctor Service of Australia (Central Operations)
RFDSQ	Royal Flying Doctor Service of Australia (Queensland Section)
RFDSW	Royal Flying Doctor Service of Australia (Western Operations)
RPT	Regular Public Transport
RVAC	Royal Victorian Aero Club
SFC	Singapore Flying College
SFCJ	Singapore Flying College (Jandakot)
SMABC	Sydney Metropolitan Airport Business Council Inc.
stand-alone costs	the cost to a multi-product or service firm of providing a particular service (or group of services), considered in isolation of its other products/services
TAR	Terminal Area Radar
TCU	Terminal Control Unit
TFP	total factor productivity: the ratio of an index of aggregate output to an index of aggregate input.
TN	Terminal Navigation
vanilla WACC	the weighted average of the post-tax return on equity and the pre-tax cost of debt
VRAC	Victorian Regional Air Charter Pty Ltd
WACC	weighted average cost of capital

WCI	wage cost index; an Australian Bureau of Statistics price index which measures changes over time in wage and salary costs for employees jobs, unaffected by changes in the quantity of work performed

Summary

On 12 August 2004 the Australian Competition and Consumer Commission (ACCC) received a draft price notification from Airservices Australia (Airservices), proposing changes to the pricing of its regulated services.

The regulated services provided by Airservices are aviation en route navigation (en route), aviation terminal navigation (TN) and aviation rescue and fire-fighting (ARFF). Charges for these services are levied on airlines and other operators of aircraft landing at Airservices controlled airports in Australia and flying in airspace controlled by Airservices.

This draft proposal has been provided to the ACCC in advance of a formal price notification under the provisions of Part VIIA of the *Trade Practices Act 1974* (the Act) to allow the ACCC to consult on and consider the proposal. This proposal covers a five-year period from 2004–05 to 2008–09 and is the first such long-term pricing proposal from Airservices. It follows comments made in the past by the ACCC in support of Airservices developing longer-term pricing arrangements in consultation with its users, rather than the short-term approach to pricing which Airservices has adopted in the past.

The ACCC welcomes this draft price notification and Airservices' approach in working together with its customers to develop a longer-term pricing plan. The major airlines have been very positive about the increased transparency and co-operative approach that Airservices has taken. The ACCC considers that such an approach has the potential to provide real benefits to both Airservices and the industry. These benefits include increasing certainty for users of Airservices' services, increasing the understanding of Airservices' customers of the way in which Airservices operates and the factors affecting its costs and providing scope for enhancements to the sharing of risks between Airservices and its stakeholders.

However, concerns have been expressed in submissions to the ACCC from regional and general aviation (GA) interests, relating particularly to the structure of Airservices' pricing.

While the ACCC is not opposing the revenue estimates underlying the proposed prices, the ACCC has an immediate concern with the **basis** for imposing charges for ARFF services, which it considers should be addressed before introducing long-term pricing arrangements. The ACCC considers that the proposed pricing structure would have a large impact on smaller operators at Maroochydore, Townsville and Ayers Rock airports, where ARFF services have recently been or will be introduced as a result of the high passenger numbers of regular public transport flights. Therefore the ACCC's preliminary view on Airservices' draft price notification is to object to the price increases proposed for ARFF and to not object to the price changes proposed for TN and en route.

The ACCC is particularly interested in additional views from interested parties on the appropriate basis for imposing ARFF charges.

Airservices' proposal

Airservices is proposing a five-year pricing structure for each of its three declared services covering the periods 2004–05 to 2008–09. Individual prices are proposed for each of the locations at which Airservices provides a TN service and at each location at which it provides an ARFF service. The full details of these prices are shown in Table 1.1.

In aggregate, Airservices proposes to increase the price of TN services over the five-year period by 23.5 per cent in nominal terms and ARFF services by 34.1 per cent (excluding the price increases arising from the introduction of new ARFF services in the first year of the proposal). In contrast the price of the en route service is proposed to reduce in nominal terms by 10.3 per cent over the five-year period.

These relative price changes are concentrated in the first year of the proposal, with the weighted average price of TN services increasing by 15.5 per cent in the first year, followed by annual increases of 3 per cent, 2.1 per cent, 1.2 per cent and 0.5 per cent. Similarly, the corresponding price increases for ARFF services are 15.9 per cent, 6.3 per cent, 3.8 per cent, 3.2 per cent and 1.6 per cent. At individual locations, the maximum increases in prices are 16.8 per cent in year one and 10 per cent in each of the following four years.

A major cause of these relative price changes is Airservices' desire to reduce the level of cross-subsidies between services and locations in its pricing structure, in the context of the removal of price caps for TN services at regional and general aviation (GA) locations and the end to an Australian Government subsidy. Airservices is also estimating substantial increases in both its operating and maintenance expenditure (opex) and capital expenditure (capex) over the five-year period.

Long-term pricing plan

Airservices has devised its pricing proposal in consultation with users, involving the formation of an Industry Steering Committee (ISC) and working group and through separate consultations with regional and GA users. Airservices' customer and stakeholder base is both diverse and geographically dispersed, including international and domestic regular public transport (RPT) airlines, regional airlines, aero-medical services, flying schools, sport and recreational flyers and private operators, as well as airports and government departments and agencies.

The ACCC welcomes the approach Airservices has taken in developing longer-term pricing arrangements in consultation with its customers and particularly the increased transparency in Airservices' costs and operations, attested to by a number of those involved in the ISC and working group. However, this has not extended to Airservices' wider stakeholder base, which is evident in the submissions the ACCC has received. The ACCC acknowledges Airservices' attempts to engage regional and GA stakeholders and appreciates the practical difficulties of this and considers that it will be important for both Airservices and regional and GA stakeholders to work together to enhance future consultation processes, particularly where regional and GA interests are directly affected.

The pricing plan Airservices is proposing sets individual prices on the basis of revenue proposals and estimated activity levels at each location. In the absence of any ability to reopen these prices within the five-year period, Airservices would potentially be exposed to both the risks and rewards of lower or higher revenue resulting from costs differing from forecast or activity differing from forecast. However, Airservices has proposed a number of trigger mechanisms, which may result in prices being reviewed. These triggers relate to new regulatory or customer requirements, deviations in capex and deviations in activity levels. Airservices has stated that the occurrence of such triggers would result in it consulting with the ISC on the best means of dealing with the impact of the event, which may include absorption of the cost of the impact, changes to service levels or a price change. Any proposal for a price increase would go through the price notification provisions of the Act.

The ACCC has in the past favoured Airservices developing longer-term pricing arrangements to provide for a better sharing of risk between Airservices and its customers. The ACCC considered that Airservices should bear more risk for the management of costs and changes in activity than it otherwise would have under a short-term pricing arrangement. The inclusion of trigger mechanisms in Airservices' proposal makes it unclear what the resulting sharing of risks will be in practice and it is therefore unclear to the ACCC whether Airservices is taking on any additional level of risk. Nevertheless the ACCC recognises that the proposed arrangements appear to have a broad level of acceptance within Airservices' stakeholder base and the proposed approach provides the opportunity for Airservices to continue to increase the level of transparency of its costs and operations.

In particular, in relation to the ongoing development of Airservices' capex program and in considering how to respond to revised priorities and/or timing, the ACCC encourages Airservices to increase the transparency in the information provided to stakeholders.

The approach that Airservices has taken to risk-sharing arrangements, including its approach to estimate levels of activity, is focused on its business at an aggregate level. However, the application of location-specific pricing means that impacts which may not significantly impact on Airservices' costs or revenues may have a significant impact on particular smaller locations or businesses with an interest in such locations. The ACCC therefore considers that there may be merit in Airservices and particular airports entering into individual risk-sharing arrangements.

Building block methodology for assessing allowable revenue

Table 7.1, below, reproduced from chapter 7 of this document, sets out Airservices' proposed revenue underlying its proposed price changes.

Table 7.1: Airservices' proposed building blocks ($million)

	2004–05	2005–06	2006–07	2007–08	2008–09	Total	% of revenue
Return on assets	39	43.1	46.9	49.5	51.4	229.9	7.08
Total OPEX (excl dep)	482.4	507.7	519.7	538.6	555.8	2604.2	80.19
Depreciation	77.1	74.4	76.8	78.6	78.3	385.2	11.86
Tax	4.8	5.3	5.8	6.1	6.3	28.3	0.87
Revenue	**603.3**	**630.5**	**649.2**	**672.8**	**691.8**	**3247.6**	**100**

As shown in Table 7.1, opex is the major component of Airservices' proposed allowable revenue. Airservices estimates an increase in opex in 2004–05 of $34.2 million, or 7.6 per cent, with subsequent lesser rates of increases, averaging 3.8 per cent per annum in nominal terms between 2005–06 and 2008–09. The ACCC has not been able to make a full assessment based on information supporting this draft price notification as to whether Airservices is currently operating at efficient levels. This factor, combined with the lack of a formal and explicit efficiency incentive by Airservices to further reduce costs are a concern and the ACCC encourages Airservices, together with its stakeholders, to develop independent benchmarks and an incentive mechanism for future long-term pricing proposals.

Consideration of the limited benchmarking information made available to the ACCC and the views expressed in submissions have lead the ACCC to accept the base level of opex forecast by Airservices for the purpose of this assessment. The ACCC examined the reasons for the large increase in estimated opex in the first year of the proposal and considers that the estimated increases resulting from new and increased levels of service required by regulation, increases in salary costs and increases in superannuation contributions underlying the increase are reasonable.

The other elements of Airservices' allowable revenue are of a lesser magnitude and therefore form a correspondingly lesser part of the ACCC's assessment of Airservices' pricing proposal. The ACCC welcomes the approach Airservices has adopted in having the valuation of its asset base scrutinised by the ISC and endorses the approach supported by members of the ISC that the value of Airservices' asset base can now be used as a reference point for future notifications, taking into account new and efficient investment.

The capex program of $542 million over the five-year period proposed by Airservices is large relative both to its past levels of capex and its existing asset base. The ACCC recognises that Airservices' capex program has been developed in consultation with industry and is also supported by its major customers and accepts the capex estimates for the purposes of this pricing proposal.

The rate of return applied to Airservices' asset base determines the amount of return on capital allowed. Airservices' pricing proposal consists both of a 'normal' rate of return as well as a 'phasing in' of the rate of return over the period of the proposal. The ACCC is of the view that an appropriate value for Airservices' weighted average cost of capital (WACC) is 8.95 per cent. This is based on lower values for the risk-free rate, the asset and equity betas and the debt margin than those values recommended by Pricewaterhouse Coopers (PwC) in a report commissioned by Airservices. The ACCC does not support Airservices' approach of phasing in its WACC over the period of the pricing proposal. Changes to the WACC should only be made to reflect changes in its underlying parameters.

Given that the effect on revenue of Airservices' phasing in of its WACC is greater than the effect of the ACCC's view of the appropriate rate of WACC, the ACCC accepts the values for return on capital and therefore also the total revenue amounts proposed by Airservices.

Activity levels and forecasts

Forecasts of activity are used by Airservices to translate its aggregate revenue amounts into individual prices. The ACCC welcomes the approach taken by Airservices in commissioning independent forecasts of activity from the International Air Traffic Association (IATA). While interested parties generally consider these forecasts to be appropriate at the larger locations, views differ as to the forecasts applying to smaller locations. The ACCC considers that the use of generalised growth rates for activity is a reasonable approach; however, as mentioned earlier, there may be merit in Airservices and particular airports entering into individual risk-sharing arrangements, particularly regarding the levels of activity at particular locations.

Structure of pricing

The ACCC has considered the structure of Airservices' proposed prices from the perspectives both of economic efficiency and equity.

The ACCC considers that Airservices' approach to allocating the common costs of each of its TN and ARFF services to locations based on activity measured in tonnes landed appears to be broadly on the basis of different demand elasticities and is therefore consistent with economic principles. The approach is one which is reasonably likely to result in allocations which broadly reflect users' capacity to pay and is a reasonable and transparent approach to cost allocation.

The ACCC sees potential merit in incorporating demand-side interdependencies (such as movement congestion in a common basin airspace) into the pricing for TN services. However, given the lack of quantification of these effects, the ACCC is unable to adequately assess Airservices' proposal of 'basin pricing' of its TN services.

The ACCC considers it appropriate that Airservices has adjusted its original approach to immediately introduce price increases resulting from increased costs and desired changes in the relativities of prices to an approach of phasing in such price changes. While Airservices' proposal is still front-loaded, with maximum price increases in the first year of the proposal being the highest at 16.8 per cent (in line with a ministerial direction) in the context of estimated costs being significantly higher than the

proposed prices, Airservices' approach of moving to a closer alignment of prices with costs in the first period appears to be reasonable.

The ACCC does not agree with views expressed by some parties that Airservices should revert to a network pricing approach. The ACCC considers that this would be unlikely to advance either efficient or equitable outcomes. Network pricing is more likely to exacerbate productive inefficiency because the costs of providing services are not targeted directly to those using the service. In addition, there is an equity argument against customers being required to pay more than the cost of providing the service to them.

In response to submissions from the larger passenger airlines, the ACCC analysed whether Airservices' pricing structure entails a cross-subsidy in the pricing of TN, ARFF and en route services; and between locations in the pricing of TN and ARFF services. While Airservices is not currently subject to competition for its regulated services, the ACCC considers that the question of cross-subsidy is relevant in examining the reasonableness or fairness of prices. The ACCC found that there appears to be a degree of cross subsidisation of TN and ARFF services at regional and GA locations by en route and TN services at radar locations. The ACCC will continue to monitor this situation, particularly if there is a likelihood of competition being introduced to Airservices' services.

The ACCC examined concerns expressed about the basis of Airservices' charging, in terms of the unit of measurement applied as the basis for imposing charges for ARFF, TN and en route services. The ACCC has an immediate concern with the basis of charging for ARFF services. While Airservices has acknowledged that the issue of ARFF charging should be considered further, it has not addressed this question as part of this long-term pricing notification. However, the ACCC considers that it should be addressed before finalisation of a long-term pricing plan is introduced. Charging ARFF services on the basis of maximum take-off weight (MTOW), with a minimum threshold of 2.5 tonnes does not appear to the ACCC to be related to the cost drivers that Airservices faces at three levels:

- in introducing a new ARFF service at a particular airport
- when considering the introduction of a new ARFF service to particular user groups at a particular airport
- in considering changes to the level of an ARFF service, once a service has been established.

The establishment criteria for ARFF services relates to the number of passengers at an airport and the type of air service landing at an airport and while there may be a high correlation between MTOW and passenger numbers, this does not appear to be the case for all types of aircraft. On the second issue, it appears to the ACCC that it may be efficient to price differentially to different user groups located at an airport, for what is essentially a common cost of providing a new ARFF service. In addition, in relation to the third issue, within certain ranges of activity, it would appear that the marginal cost to Airservices would be close to zero.

The ACCC considers that Airservices should address its concerns regarding the basis of charging for ARFF services and is particularly interested in additional views from interested parties on the appropriate basis for imposing ARFF charges.

While there are also legitimate questions raised regarding the basis of charging for TN and en route services, these matters do not appear to be as of such immediate concern as the issue of ARFF charging in the context of new ARFF services, where Airservices' proposed charges would likely have a significant effect on users and result in inefficient and inequitable outcomes.

Conclusion and preliminary view

The ACCC's discretion under the provisions of Part VIIA of the Act is essentially limited to objecting or not objecting to price notifications put before it.[1]

The ACCC accepts the overall revenue amounts underlying Airservices' proposed long-term pricing arrangements. However, it has an immediate concern with the basis of ARFF charges. The ACCC considers that the current basis for imposing charges is not likely to be efficient or equitable and the introduction of new ARFF services using the existing basis of charging is likely to have large impacts on particular user groups. The ACCC therefore considers that Airservices should address this issue of its charging structure before introducing long-term pricing arrangements.

The ACCC's preliminary view is to object to Airservices' price increases proposed for ARFF and to not object to the price increases proposed for TN and en route.

The ACCC is now seeking comments on this preliminary view. Submissions should be delivered to the ACCC by close of business on **Monday, 29 November 2004** and addressed to:

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

Alternatively, submissions may be emailed to the following addresses:

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

Following receipt of a formal price notification from Airservices, the ACCC has 21 days in which to release a final decision. The ACCC expects to release a decision on a formal price notification in December 2004.

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[1] Under section 95Z(6)(c), the ACCC may also suggest lower prices that it considers should apply. However, it has no power to impose any such prices.

Part A Introduction

On 12 August 2004 the ACCC received a draft price notification from Airservices Australia (Airservices) proposing changes to the pricing of certain services. The lodgement of the proposal followed preliminary discussions with the ACCC and is intended to be followed by the formal notification of a proposed increase in price pursuant to Part VIIA of the *Trade Practices Act 1974* (the Act) later in the year. The proposal is available on the ACCC's website at www.accc.gov.au.

This draft price notification covers a five-year period and is the first such long-term pricing proposal from Airservices.

The ACCC released an issues paper relating to Airservices' draft price notification on 17 August 2004, calling for submissions by close of business on 14 September 2004. Thirty-nine responses were received. A list of the submissions is contained in appendix A.

Airservices is proposing:

- a weighted average increase for terminal navigation (TN) services of 15.5 per cent in 2004–05 with a total weighted average increase of 23.5 per cent over five years
- a weighted average increase for aviation rescue and fire-fighting (ARFF) services of 15.9 per cent in 2004–05 (excluding price increases resulting from the introduction of new ARFF services) with a total weighted average increase of 34.1 per cent over five years
- a decrease of 5.2 per cent in en route charges for 2004–05 with a total decrease of 10.3 per cent over five years.

The ACCC last received a notification from Airservices on 26 May 2004. In that case, the ACCC did not object to Airservices continuing to charge its current prices (rather than reducing prices on 1 July 2004 to June 2002 levels) to 31 December 2004, until its five-year pricing model is introduced.

The remainder of this part of the document provides details about Airservices and the legislative framework under which it operates, Airservices' pricing proposal and the legislative framework which governs the ACCC's decision making relevant to this pricing proposal.

1 About Airservices

Airservices is a statutory monopoly established under the *Air Services Act 1995* (AS Act). It is a commercial authority responsible for a range of functions including safe and environmentally sound air traffic management and related services. It also has a responsibility under the AS Act to promote and foster aviation.

Airservices' en route air navigation services cover approximately 11 per cent of the world's airspace which includes not only Australia's sovereign airspace, but also international airspace over the Pacific and Indian Oceans.

Airservices is a very significant organisation within the Australian aviation industry, generating over $617 million in total annual revenue in 2002–03. By way of comparison, Airservices' charges are of similar significance to airlines as the fees and charges levied by airports. In 2002–03 Airservices generated $487 million in airways revenue, compared with a total of $494 million in aeronautical revenue generated by Australia's seven price-monitored airports.

Legislative framework

This section outlines the main provisions of the AS Act and the *Commonwealth Authorities and Companies Act 1997* (CAC Act) under which Airservices currently operates.

1.1.1 Airservices Australia's functions

Under s. 8 of the AS Act, Airservices is responsible for:

- providing services and facilities
  - for the purpose of giving effect to the Chicago Convention
  - for the purpose of giving effect to another international agreement relating to the safety, regularity or efficiency of air navigation
  - for other purposes relating to the safety, regularity or efficiency of air navigation, both within and outside Australia
- promoting and fostering civil aviation, in or outside Australia
- cooperating with the Executive Director of Transport Safety Investigation in investigating aircraft safety issues and incidents
- carrying out activities to protect the environment from the effects of, and effects associated with, the operation of:
  - Commonwealth jurisdiction aircraft
  - other aircraft outside Australia

- any function prescribed by regulations in relation to effects of and effects associated with Commonwealth jurisdiction aircraft, or other aircraft outside Australia

- any functions conferred under the *Air Navigation Act 1920*

- any other function prescribed by regulations

- providing consultancy and management services relating to any of the above matters

- any incidental functions

- providing services and facilities that use Airservices' spare capacity, improve the technical skills of Airservices' staff and do not impede Airservices' capacity to perform other functions.

Airservices may provide its services and facilities both within and outside Australian territory.[2]

In performing its functions, Airservices is required by s. 9 of the AS Act to regard the safety of air navigation as the most important consideration. Under s. 10, Airservices is required to consult with government, commercial, industrial, consumer and other relevant bodies in performing its functions and exercising its powers. In 1998 the government amended s. 8 of the AS Act to require Airservices to operate in a way that promotes the aviation industry.

1.1.2 Ministerial role in price setting

Under s. 53 of the AS Act, the Board of Airservices may set charges for services and facilities. Under s. 54, however, the Board must provide the Minister with written notice of the proposed determination and the Minister may approve or disapprove the proposed determination. Subsection 54(3) states that the Board may only make its determination if it has been approved by the Minister or if the period by which the Minister must provide the Board with a notice has expired.

1.1.3 Corporate plan

In preparing a corporate plan under s. 17 of the CAC Act, Airservices is required under s. 13 of the AS Act to consider eight matters including:

- the need for aviation safety

- the need to maintain a reasonable level of reserves with consideration to future infrastructure requirements

- the need to earn a reasonable rate of return on assets (other than assets wholly or principally used in search and rescue services)

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[2] *Air Services Act 1995* (Cwlth) s. 8(2).

- the expectation of the government that Airservices will pay a reasonable dividend.

Under s. 14 the Minister may direct changes to the corporate plan regarding financial targets and performance indicators.

1.1.4 Minister's directions under s. 16 of AS Act

Under s. 16 of the AS Act, the Minister may give written directions to Airservices about the performance of its functions. Particulars of any directions are to be included in Airservices' annual report.

If Airservices satisfies the minister under subs. 16(4) of the AS Act that it will incur financial detriment by complying with a direction, the government may provide reimbursement. Financial detriment is taken to include incurring costs that are greater than would otherwise have been incurred and forgoing revenue that would otherwise have been received.

Recent changes to airspace regulation

On 1 April 2004 the Australian Government announced that Airservices would lose its regulatory function.[3] This means that Airservices will no longer be responsible for matters such as the classification of airspace and the designation of air routes. This role will be transferred to an Airspace Authority which will be created within the Department of Transport and Regional Services.[4]

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[3] Minister for Transport and Regional Services, John Anderson, 'Changes to airspace regulation in Australia' (media release, 1 April 2004).

[4] The date of the transfer depends on the date of CASR Part 71 coming into force, which has not been finalised.

2 Airservices Australia's proposal

Background

The ACCC expects Airservices to submit a price notification under Part VIIA of the Act later this year for its declared services covering the period 2004–05 to 2008-09.

The proposal contained in the draft price notification has been developed following initial consultations with major airlines and representative bodies, including Qantas, Virgin Blue, Board of Airline Representatives of Australia Inc (BARA) and International Air Transport Association (IATA). An Industry Steering Committee (ISC) was established with the major users and meetings were held from August 2003 up to the submission of the draft price notification. Airservices has made available the minutes of these meetings.

While Airservices invited the Regional Aviation Association of Australia (RAAA) and Aircraft Owners and Pilots Association (AOPA) to participate in this consultation process, they did not attend these meetings, so there were no representatives of general aviation (GA) or regional interests involved. In the 2004 federal budget, the government announced that the current annual subsidy (of $7 million) provided to offset Airservices' costs of providing TN services at regional locations would be discontinued after 2004–05. It also announced that the price caps applying at these locations would increase by 16.8 per cent to $8.67 in 2004–05 and cease to apply from 2005–06.

Subsequent to this decision, Airservices undertook consultations with GA and regional operators during June and July 2004. Airservices sent mail-outs to 7000 customers and received more than 600 written submissions in response. Airservices also conducted on-airport meetings with stakeholders and took into account views expressed in this process to modify its initial proposal.

Airservices' proposed price increases are outlined in Table 2.1. Airservices is not proposing to change the existing basis of its charges, the full details of which are set out in its standard contract terms.[5] In broad terms, charges for TN and ARFF services are on the basis of each tonne of the maximum take-off weight (MTOW) of the aircraft and the en route charge is a function of both the weight in tonnes and the distance flown.

[5] Airservices Australia, *Charges for Facilities and Services, Standard Contract Terms 1 July 2004*, at www.airservicesaustralia.com

Table 2.1 Airservices' proposed price increases by location

Proposed Prices for Airways Services

	Prices (incl GST)						Price Change				
	Current	Oct 04	1 Jul 05	1 Jul 06	1 Jul 07	1 Jul 08	Oct 04	1 Jul 05	1 Jul 06	1 Jul 07	1 Jul 08
ARFF											
Adelaide	$ 2.69	$ 3.14	$ 3.35	$ 3.35	$ 3.35	$ 3.35	16.7%	6.7%	-	-	-
Alice Springs	$ 6.81	$ 7.95	$ 8.75	$ 9.63	$ 10.59	$ 11.65	16.7%	10.1%	10.1%	10.0%	10.0%
Brisbane	$ 1.46	$ 1.70	$ 1.76	$ 1.76	$ 1.76	$ 1.76	16.4%	3.5%	-	-	-
Cairns	$ 3.83	$ 4.31	$ 4.31	$ 4.31	$ 4.31	$ 4.31	12.5%	-	-	-	-
Canberra	$ 3.58	$ 4.18	$ 4.60	$ 5.06	$ 5.33	$ 5.33	16.8%	10.0%	10.0%	5.3%	-
Coolangatta	$ 4.24	$ 4.95	$ 5.09	$ 5.09	$ 5.09	$ 5.09	16.7%	2.8%	-	-	-
Darwin	$ 7.23	$ 8.44	$ 9.28	$ 10.21	$ 11.23	$ 11.95	16.7%	10.0%	10.0%	10.0%	6.4%
Hobart	$ 8.46	$ 9.88	$ 10.16	$ 10.16	$ 10.16	$ 10.16	16.8%	2.8%	-	-	-
Launceston	$ 9.30	$ 10.86	$ 11.95	$ 13.15	$ 14.47	$ 15.92	16.8%	10.0%	10.0%	10.0%	10.0%
Mackay	$ 9.98	$ 11.66	$ 12.83	$ 14.11	$ 15.52	$ 17.07	16.8%	10.0%	10.0%	10.0%	10.0%
Melbourne	$ 1.09	$ 1.27	$ 1.40	$ 1.41	$ 1.41	$ 1.41	16.5%	10.2%	0.7%	-	-
Perth	$ 2.40	$ 2.74	$ 2.74	$ 2.74	$ 2.74	$ 2.74	14.2%	-	-	-	-
Rockhampton	$ 9.59	$ 11.20	$ 12.32	$ 13.55	$ 14.91	$ 16.40	16.8%	10.0%	10.0%	10.0%	10.0%
Sydney	$ 0.69	$ 0.80	$ 0.88	$ 0.97	$ 1.04	$ 1.04	15.9%	10.0%	10.2%	7.2%	-
Weighted Average ARFF							**15.9%**	**6.3%**	**3.8%**	**3.2%**	**1.6%**
TERMINAL NAVIGATION											
Alice springs	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Hobart	$ 7.42	$ 8.67	$ 9.54	$ 9.54	$ 9.54	$ 9.54	16.8%	10.0%	-	-	-
Launceston	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.22	16.8%	10.0%	10.0%	10.0%	5.9%
Mackay	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Rockhampton	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Maroochydore	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Coffs Harbour	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Albury	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Tamworth	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Hamilton Island	$ 5.38	$ 6.28	$ 6.91	$ 7.60	$ 8.36	$ 9.20	16.7%	10.0%	10.0%	10.0%	10.0%
Weighted Average Regional							**16.8%**	**10.0%**	**7.7%**	**7.9%**	**7.5%**
Cairns *	$ 8.75	$ 10.22	$ 10.95	$ 10.95	$ 10.95	$ 10.95	16.8%	7.1%	-	-	-
Canberra *	$ 9.50	$ 11.10	$ 12.21	$ 12.66	$ 12.66	$ 12.66	16.8%	10.0%	3.7%	-	-
Coolangatta *	$ 9.99	$ 10.82	$ 10.82	$ 10.82	$ 10.82	$ 10.82	8.3%	-	-	-	-
Adelaide	$ 9.74	$ 11.38	$ 11.43	$ 11.43	$ 11.43	$ 11.43	16.8%	0.4%	-	-	-
Parafield (AD Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Brisbane	$ 4.96	$ 5.79	$ 5.83	$ 5.83	$ 5.83	$ 5.83	16.7%	0.7%	-	-	-
Archerfield (BN Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Melbourne	$ 3.45	$ 4.03	$ 4.43	$ 4.87	$ 5.06	$ 5.06	16.8%	9.9%	9.9%	3.9%	-
Moorabbin (ML Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Essendon (ML Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Perth	$ 7.49	$ 8.63	$ 8.63	$ 8.63	$ 8.63	$ 8.63	15.2%	-	-	-	-
Jandakot (PH Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Sydney	$ 4.82	$ 5.57	$ 5.57	$ 5.57	$ 5.57	$ 5.57	15.6%	-	-	-	-
Bankstown (SY Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Camden (SY Basin)	$ 7.42	$ 8.67	$ 9.54	$ 10.49	$ 11.54	$ 12.69	16.8%	10.0%	10.0%	10.0%	10.0%
Weighted Average -Capital/Major							**15.8%**	**2.7%**	**1.9%**	**0.8%**	**0.2%**
Darwin	$ 3.31	$ 3.10	$ 2.89	$ 2.68	$ 2.47	$ 2.26	(6.3%)	(6.8%)	(7.3%)	(7.8%)	(8.5%)
Townsville	$ 4.76	$ 4.40	$ 4.03	$ 3.67	$ 3.30	$ 2.94	(7.7%)	(8.3%)	(9.0%)	(9.9%)	(11.0%)
Weighted Average Navaid Ports							**(7.0%)**	**(7.5%)**	**(8.1%)**	**(8.8%)**	**(9.7%)**
Weighted Average TN							**15.5%**	**3.0%**	**2.1%**	**1.2%**	**0.5%**
ENROUTE											
Enroute > 20 tonnes	$ 4.66	$ 4.42	$ 4.37	$ 4.26	$ 4.22	$ 4.18	**(5.2%)**	**(1.1%)**	**(2.5%)**	**(0.9%)**	**(0.9%)**
Enroute < 20 tonnes	$ 1.04	$ 0.99	$ 0.98	$ 0.95	$ 0.94	$ 0.93	(5.2%)	(1.1%)	(2.5%)	(0.9%)	(0.9%)
EXISTING SERVICES - Weighted Average							**4.0%**	**1.3%**	**0.0%**	**0.4%**	**(0.0%)**
New ARFF Services											
Ayers Rock	$ 13.09	$ 15.29	$ 16.82	$ 17.12	$ 17.12	$ 17.12	16.8%	10.0%	1.8%	-	-
Maroochydore	$ -	$ 15.29	$ 16.82	$ 18.50	$ 20.35	$ 22.39		10.0%	10.0%	10.0%	10.0%
Townsville	$ -	$ 10.37	$ 10.37	$ 10.37	$ 10.37	$ 10.37		-	-	-	-

Note: Cairns, Canberra & Coolangatta aircraft <5.7tonne will be charged at the lower of the capped rate for regional towers or the full price in each year

Table 2.2 summarises Airservices' proposed annualised price changes.

Table 2.2 Airservices' 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%
En route	-5.2%	-1.1%	-2.5%	-0.9%	-0.9%	-10.3%
Weighted average *[Incl. new services]*	**4.0%** *[5.2%]*	**1.3%**	**0.0%**	**0.4%**	**0.0%**	**5.8%**

As outlined in Table 2.2 Airservices' proposal includes a weighted average price increase at the commencement of the long-term arrangement of 5.2 per cent (or 2.8 per cent in real terms). Excluding the impact of new ARFF services, the weighted average price increase across services is 4 per cent. During the course of the remaining four years it is proposed that overall prices will increase by a total of approximately 1.7 per cent or reduce in real terms.

Activity forecasts

Underlying Airservices' proposed prices are forecast activity levels. These forecasts are based on a report from IATA's Forecasting and Consulting Unit and are shown in Table 2.3.

Table 2.3 Forecast activity growth rates

	2004–05	2005–06	2006–07	2007–08	2008–09
En route	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%
GA airports	1.0%	2.0%	2.0%	2.0%	1.8%
Weighted average	**4.7%**	**4.9%**	**4.1%**	**3.9%**	**4.7%**

As part of its long-term pricing plan, Airservices proposes that if activity levels fall or rise by 10 per cent or more within a 60-day period and/or are forecast to trend 5 per cent above or below the forecast quantitative levels in a financial year, Airservices, together with the ISC will consider the most appropriate means of addressing the situation, such as agreement to change cost levels through a change in service levels, a re-scheduling of capital expenditure (capex) or seeking a price variation.

Operating and maintenance costs

Airservices states that its opex projections were developed in consultation with the ISC to reflect:

- statutory obligations in relation to safety
- the cost of providing baseline services
- the impact of the capital investment program
- the projected effect of the regulatory changes in the provision of ARFF services
- continuing productivity improvements.

Airservices states that it will continue to review the ongoing requirement for more 'marginal' towers and their operating hours.

Airservices states that in 2004–05, costs are expected to increase by $34.2 million or 7.6 per cent[6] due mainly to:

- new ARFF services planned or recently established at Ayers Rock, Maroochydore and Townsville ($5.7 million)
- regulatory changes for ARFF ($6.6 million)
- additional Air Traffic Control (ATC) training requirements ($3.9 million)
- increases in staff and supplier costs ($20.5 million).

Asset base

Airservices' proposed value for its regulatory asset base reflects the outcomes of a report by Hymans Asset Management (Hymans). Hymans' valuation of Airservices' assets, as at September 2003, was $338 million, an increase in the value of assets of $41.7 million (14 per cent).

The 14 per cent increase in the asset base was explained as primarily reflecting the reversal of a one-off asset write down in 1999 of almost $100 million to reduce the value of assets at loss making locations to zero in accordance with accounting standards.

Capital expenditure

Airservices has proposed a $542 million capex program over the period 2004–05 to 2008–09. Airservices has developed its capex program in response to the *Australian*

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[6] As is conventional, depreciation charges have been excluded from this discussion of operating costs and are considered in the asset base section of the report.

Air Traffic Management Strategic Plan: 2003-2015 issued by the Australian Strategic Air Traffic Management Group (ASTRA), of which Airservices is a member.

The ISC endorsed the capex program although reservations were expressed by some parties about the requirement for surface movement guidance systems ($14.6 million) proposed at Brisbane and Melbourne airports.[7]

Airservices proposes that if actual capex is anticipated to deviate from forecast by 50 per cent or more in a particular year, or by 25 per cent cumulatively, as a result of revised priorities or timing, it will consult with the ISC on the best means of dealing with the event.

Rate of return

Airservices is proposing nominal vanilla weighted average cost of capital (WACC) values which vary over the life of the pricing proposal, as set out in Table 2.4, below.

Table 2.4 Airservices' target WACC profile—2004–05 to 2008–09

	2004–05	2005–06	2006–07	2007–08	2008–09
Increasing WACC target	6.00%	7.25%	8.50%	9.25%	9.75%

The value of 9.75 per cent, as proposed to apply in 2008–09, is based on a recommendation by Pricewaterhouse Coopers (PwC), which was engaged by Airservices. However, Airservices has proposed to 'phase in' this WACC value, to bear some of the cost of transitioning to its proposed new pricing structure. Airservices stated that this would act as a formal incentive on it to seek additional productivity efficiencies to achieve a normal return during this period.

Structure of pricing

Airservices applies a location-specific pricing approach for TN and ARFF services and a single price for its en route service.

Airservices' proposed pricing path features:

- phasing in of higher prices, off-setting the impact of the expiration in June 2005 of the Australian Government subsidy for regional and GA TN services
- a revised cost allocation methodology for overheads and distributed costs based on activity levels, which takes into account users' capacity to pay

[7] Airservices Australia, 'Draft price notification', August 2004, p. 19. Airservices states that as a result of this it has been working closely with the Brisbane and Melbourne Safety Committees to confirm its understanding that the proposed investment is the most appropriate solution to mitigating safety risks. Airservices states that final resolution of the issue, including any necessary adjustments, will be made before lodgement of the final notification.

- adoption of a 'basin' concept for pricing at GA aerodromes situated in capital city locations.

Airservices breaks down its cost allocation by cost type into the following categories:

- direct costs
- shared services
- asset cost—facility management and maintenance
- asset cost—direct depreciation
- distributed costs.

In allocating costs to individual regulated services at particular locations, a mix of direct costing, activity based allocation and generic allocation methods is applied. Airservices has adjusted its cost allocation approach towards one that takes into account users' capacity to pay. In particular, it is proposed distributed costs (specialist support costs, group and corporate overheads) be allocated within each service line based on the chargeable units (e.g. tonnes landed) underpinning the service. Airservices argues that it is more price efficient to recover these costs in line with the customer's capacity to pay. As a result of this, Airservices states that a proportionately higher level of these costs will be recovered from Sydney, Melbourne and Brisbane users.

Airservices has also applied a 'basin concept' in pricing for TN services at airports located in major capital city metropolitan regions. This approach spreads the costs of airports located within the major capital city areas and is justified on the basis of interdependencies that exist between the operations of these airports, where the existence of the secondary airports has the effect of reducing congestion at the primary airport.

Impact on users

Airservices states that the impact of the proposed price changes on major routes (international and domestic) is not expected to be material. Airservices submits that the largest increase on the top 25 routes (based on revenue), in relation to a low internet ticket price, is estimated at $0.69 or 1.1 per cent.

Airservices estimates the impact of the proposed increases in TN and ARFF prices per ticket will range from $0.49 to $1.89 for existing services. Airservices notes that the introduction of new ARFF services at Maroochydore and Townsville is more significant and increases are expected to be approximately $6.46 and $10.67 per ticket (respectively). Airservices also states that the impact of the proposed increases on GA training prices indicates that it would cost an additional $5 per hour at the end of the five-year period.

3 Legislative Framework

The provision of air traffic control and ARFF is declared under s. 95X of the Act.[8] The relevant declaration, declaration number 66, is available from the ACCC website, www.accc.gov.au. Under s. 95Z of the Act, Airservices is required to notify the ACCC of proposed increases in prices of these declared services. The ACCC is then responsible for assessing the proposed price increases and can either object to the proposed increases, not object to the increases, or not object to increases lower than those proposed.

The object of prices surveillance (as set out in Part VIIA of the Act) is to address markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers.[9] In considering a notification, the ACCC is also required to have particular regard to the matters set out in section 95G(7) of the Act. This subsection specifies that in assessing a notification, the ACCC should particularly consider the need to:

- maintain investment and employment, including the influence of profitability on investment and employment
- 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
- discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC believes that an important consideration regarding these first two criteria is that efficient provision of services underpins investment and employment opportunity in an open and competitive market economy. Investment and employment in the national economy will be promoted when firms produce goods or services efficiently and charge prices which correspond as closely as possible to competitive levels.

Monopoly suppliers do not necessarily produce goods or services at efficient cost levels or at competitive prices. If higher than efficient prices for intermediate services and products are passed on to the rest of the economy, there is a resultant loss in technical and allocative efficiency and potentially therefore in investment and employment opportunity.

The ACCC believes that encouraging efficient pricing outcomes in line with more competitive conditions implies that price increases should stem from an efficient cost base which involves only appropriate margins.

Given this broad context the ACCC, in assessing price notifications, will consider:

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[8] The declaration originally had effect under the *Prices Surveillance Act 1983*, but now has effect under Part VIIA of the Trade Practices Act.

[9] Section 95E of the Act.

- the efficiency of the cost base that the declared company is working from to earn a return

- the reasonableness of the rate of return that the declared company is seeking.

The third criterion outlined in subs. 95Z(7)(c) does not appear to be directly relevant to this price notification.

More detail on these and other aspects of the ACCC's approach to price notification is contained in its *Draft statement of regulatory approach to price notifications*, available on the ACCC website.[10]

[10] The ACCC is currently revising these guidelines to reflect the prices surveillance regime now incorporated into Part VIIA of the Act.

4 Airservices' previous notifications

On 25 July 2002 the ACCC decided to not object to a price notification by Airservices which proposed increased prices to apply from 28 July 2002 to 30 June 2003 ('2002–03 prices') upon which prices would revert to June 2002 prices. The reasons for the ACCC's decision are set out in *Airservices Australia: Proposed Price Increase: Position Paper* (24 July 2002).

On 19 June 2003 the ACCC received a price notification from Airservices which proposed a 6.95 per cent increase in TN and ARFF charges to apply to 30 June 2004 upon which prices would revert to 2002–03 prices. On 26 June 2003 the ACCC decided to not object to lower prices, being the continuation of the 2002–03 prices until 30 June 2004 after which prices would revert to June 2002 prices. The reasons for the ACCC's decision are set out in *Decision: Airservices Australia: Proposed Price Increase* (June 2003). In summary, the ACCC considered that Airservices should develop a longer-term pricing model in consultation with its customers before submitting any future requests for price increases. On 30 June 2003 Airservices notified the ACCC that it accepted the lower prices specified by the ACCC and that it would develop a longer-term pricing model.

On 26 May 2004 the ACCC received a price notification from Airservices proposing that the current prices remain in place until 31 December 2004 upon which prices would revert to June 2002 levels. Airservices requested this extension so that it could continue to charge its current prices (rather than reducing prices on 1 July 2004 to June 2002 levels) until its five-year pricing model is finalised. On 9 June 2004, the ACCC made a decision to not object to this pricing proposal. The reasons for the ACCC's decision are set out in *Statement of Reasons: Airservices Australia: Continuation of current prices* (June 2004).

5 Process of assessment

The ACCC received a draft notification from Airservices on 12 August 2004. The ACCC released an Issues Paper on 17 August 2004 calling for submissions by close of business, 14 September 2004. A list of the submissions is set out in appendix A.

This document represents the ACCC's preliminary view of Airservices' draft notification. The ACCC is now seeking comments on this preliminary view. Submissions should be delivered to the ACCC by close of business on **19 November 2004** and be addressed to:

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

Alternatively, submissions may be emailed to the following addresses:

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

Part B The ACCC's assessment

6 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 an approach limited to a short-term horizon.

In 2002 the ACCC did not object to Airservices' price increases on a temporary basis, however, noted its expectation that in future proposals, Airservices would adopt a long-term pricing plan.

In 2003 the ACCC objected to Airservices' proposed price increases, stating the main reason for its objection was Airservices' failure to adopt a longer-term approach to pricing. The ACCC decided not to object to Airservices' current prices remaining in place for a further year, but stressed its expectation that within this period Airservices should, in consultation with its users, develop a long-term pricing plan.

Consultation process

6.1.1 Introduction

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 GA users. As part of the ACCC's consideration of Airservices' price notification, it is important to understand to what extent this proposal has been developed in consultation with Airservices' customers and stakeholders and the extent to which the proposal is supported by those parties.

Airservices has a diverse and geographically dispersed customer and stakeholder base. Its stakeholders include international and domestic regular public transport (RPT) airlines, regional airlines, aero-medical services, flying schools, sport and recreational flyers, and private operators, as well as airports and government departments and agencies.

Although Airservices has quite a diverse customer base, the vast majority of Airservices' revenue is derived from the custom of the major airlines. In addition approximately 80 per cent of Airservices' regulated revenue is collected from the capital city airports.

6.1.2 Airservices' position

Airservices commenced consultation on its long-term pricing plan in August 2003. As part of this process, Airservices invited a cross-section of international, major domestic and regional airlines, along with industry associations, representatives from airports, the GA industry and the ACCC to an inaugural consultation meeting. At this meeting, the framework for consultation on the long-term pricing proposal was agreed and an ISC was established to oversee the process, which would be supported by a smaller working group that would carry out any detailed analysis.

The ISC comprised representatives from IATA, Qantas Airways, Singapore Airlines, Virgin Blue, BARA and Airservices. The working group included representatives from Qantas Airways, Virgin Blue, BARA, and Airservices. The RAAA and AOPA were invited to participate in this consultation process, however, did not attend any of the long-term pricing consultation meetings.

The ISC agreed that the ACCC's building block model was a useful framework to evaluate the level of Airservices' allowed revenue. The foundation elements that underpin the proposed pricing strategy were then progressively considered. Through detailed analysis and the engagement of independent consultants, the ISC reviewed:

- the target rate of return on capital employed
- the capital value of existing assets
- the forecast costs by service and location
- the proposed capex program
- the forecast activity levels

Airservices states that it recognised that representatives of regional and GA operators had been difficult to engage early in the process and were not satisfactorily represented by the ISC. As a result, Airservices embarked on a consultation process with the wider group during June and July 2004. This included mail-outs to around 7000 customers, on-airport meetings with major stakeholders, the establishment of a web-site with detailed service cost and investment information for each service and briefings to various industry and government representatives.

Airservices submits that the above process bridged the consultation gap, stating that with more than 600 written responses received, it provided a sound platform to regional and GA stakeholders to enunciate their position and express their concerns. Airservices believes that it has developed a viable pricing strategy that balances the parameters agreed to by the ISC with the key concerns expressed by the regional and GA stakeholders.[11]

6.1.3 Views of interested parties

The ACCC sought comment from interested parties on the effectiveness of Airservices' consultation processes in its development of the draft price notification and the extent to which the proposal was supported by individual stakeholders.

In general, those stakeholders who participated in the ISC and working group were supportive of Airservices' proposal and the consultation process it undertook with its customers. However, the majority of regional and GA stakeholders were not satisfied with the level of consultation they received, stating that they were engaged late in the process and were not consulted on Airservices' revised proposal.

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[11] Airservices Australia, 'Draft price notification August 2004' p. 3.

BARA, Qantas and British Airways (BA) were of the view that Airservices had conducted its consultation process in a transparent manner, and along with Virgin Blue, endorsed the continuation of a consultative approach in the future.

BARA stated that the consultation process adopted by Airservices provides a model for the ongoing commercial relationship between Airservices and its airline customers, further noting that if Airservices continues to pursue these types of discussions with airlines, BARA believes that there will be continuous improvement in air traffic control services. Qantas also noted that Airservices has clearly improved the quality and effectiveness of its consultation process, stating that in its view, all interested parties have had an opportunity to participate, with Airservices providing all information requested by users.

While RAAA and Virgin Blue were also of the view that Airservices had been open and transparent in its consultation, RAAA stated that too many issues, such as tower closures or levying charges on a per passenger basis, had been left over for consideration during the life of the arrangement, and Virgin Blue considered that it appeared that the consultation towards the end of the process was limited.

Cathay Pacific and Emirates supported the view put forward by IATA in its submission, noting that they appreciated the effort and the professional approach taken by Airservices during the extensive consultation process undertaken with industry to develop a long-term price path, the detailed information and the level of transparency provided during the process.

Adelaide airport, Airport Development Group (ADG), Gold Coast airport, and Maroochy Shire Council (Maroochy SC) were satisfied in general with the consultation undertaken by Airservices. ADG noted that it met with Airservices in relation to the proposed price notification on three separate occasions and that it appreciated the consultation afforded by Airservices, specifically the personal meeting that was organised at each port.

Gold Coast Airport was of the view that in general an appropriate degree of consultation was undertaken by Airservices in this instance and it appears that the consultation process with regard to other Airservices' activities is also improving. However, the Maroochy SC stated that while the consultation process had been satisfactory in general, more information could have been given to the GA operators and others at regional airports.

Royal Victorian Aero Club (RVAC) and Victorian Regional Air Charter Pty Ltd (VRAC) claim that when consultation with GA began in June 2004 it occurred, not in a spirit of discussion and negotiation prior to decision making, but rather as an 'adversarial fight over indefensible proposals'. RVAC noted that the proof of this is the 600 submissions received by Airservices and the highly modified proposal submitted to the ACCC. RVAC stated that the GA community is fragmented, with no widely representative umbrella organisation. It submitted that this factor, together with a lack of resources, make it difficult for the GA community to effectively participate in forums such as the ISC.

The China Southern West Australian Flying College (China Southern), Department of Planning and Infrastructure Western Australia (DPIWA), General Aviation

Maintenance Pty Ltd (GAM), Jandakot Airport Chamber of Commerce (Jandakot Airport CC), Linfox, Metropolitan Ambulance Service, Royal Flying Doctor Service (Western Operations) (RFDSW), Rockhampton City Council (Rockhampton CC), Singapore Flying College—Jandakot (SFCJ) and Sydney Metropolitan Airports Business Council (SMABC) all expressed concern in relation to the level of consultation that Airservices afforded to GA operators.

China Southern noted that no GA organisation was involved in the process in its early stages, with only the major airlines participating and the GA organisation involved, AOPA, not being representative of most businesses based at towered airports. SFCJ also noted that the consultation process carried out by Airservices was limited at best, and that Airservices assumed that AOPA was able to talk on behalf of GA.

The DPIWA noted in its submission that it was concerned that the level of consultation undertaken in Western Australia was insufficient. DPIWA stated that neither the Minister for Planning and Infrastructure's office or DPIWA were consulted by Airservices during its visit to Western Australia between 16 to 18 June 2004. Further to this DPIWA also cited the Memorandum of Understanding accompanying the lease documents for Jandakot airport which indicates that Airservices would negotiate any price increases with the airport owners, however DPIWA noted that it appears that this process has not been followed.

The Jandakot Airport CC noted its concern at the almost complete lack of a proper consultative process for this price review, stating that Airservices' consultation process to date and the strategic role it plays in the Western Australian economy is 'totally flawed'.

GAM was of the view that there is a general consensus, especially from the GA community, that the level of consultation both prior to the current proposal and after has been 'extremely inadequate'.

The Metropolitan Ambulance Service stated in its submission that in June 2004 it became aware of Airservices' proposal to increase its prices. It stated that it and Air Ambulance Victoria had been omitted from the industry consultation process and duly submitted its concerns to Airservices.

Rockhampton CC noted that from its experience the consultation process with airports was 'very limited' in its scope and expectations, and it was yet to receive any answers to the questions it raised during the consultation. Rockhampton CC stated that Airservices' decision not to consult with airports in the first round of proposed price increases in 2003 indicates that it does not consider the airports to be valid customers and found Airservices' lack of customer involvement difficult to comprehend.

RFDSW stated that the absence of smaller operators from the initial consultation phase, followed by brief consultation phases in the last three months does little to enhance the relationship that Airservices may wish to have with GA participants. It would also appear to RFDSW that the larger players in the industry have dominated the consultation process.

SMABC was of the view that the level and type of consultation by Airservices with the GA industry was very poor. It noted that an examination of Airservices' web site

shows that no representative of the GA sector appears to have attended any of the four meetings held with Airservices to discuss long-term pricing policies.

Linfox outlined in its submission that to its knowledge the extent of Airservices' consultation was one meeting which occurred at Essendon airport on 18 June 2004, where approximately six of the airport's 900 annual aviation users were in attendance. Linfox submits that Airservices advised of a proposal to levy a $59 per tonne TN charge on the airport's operators and as such, no consultation occurred. At this meeting, Airservices claimed that it could not enter into any specific discussion on the proposed charge. Subsequently, many operators felt they had not been consulted.

Great Barrier Reef airport, China Southern, Mackay Port Authority (Mackay PA) and SFCJ raised concerns in relation to the time frames provided to comment on Airservices' proposal. SFCJ noted in its submission that the time frames given to reply to Airservices' proposal were too short. Singapore Flying College (SFC) and SFCJ were also of the view that a more thorough consultation process with GA stakeholders in developing the price notification may have generated a wider range of cost saving alternatives. Great Barrier Reef airport also stated that the time frames it had to respond to Airservices' notification were less than ideal, especially considering that Airservices had been aware for some time that it would be submitting its proposal to the ACCC. Further to this China Southern noted that with the limited timeframes, the effectiveness of the consultation process as well as its impact on any meaningful change could be viewed with a fair degree of scepticism.

The Mackay PA noted in its submission, that just prior to the consultative meeting at Mackay airport it was advised that the meeting with Airservices was open to all stakeholders. As a result not many GA charter operators were contacted by Airservices or were able, at late notice, to attend and express their views.

Canberra airport, the DPIWA, Linfox, the SFC Jandakot and Maroochydore branches and the SMABC stated in their submissions that they were not consulted by Airservices on the current price proposal (as opposed to the earlier proposal).

SMABC noted that no information on pricing policies had been given to itself or the operators of Bankstown airport despite requesting that industry be accorded an additional chance to comment on such pricing policies prior to them being submitted to the ACCC. SMABC also noted that it and the Bankstown operators, are 'very angry' that after requesting such advice and further consultation that this was not provided.

Canberra airport stated in its submission that, although individual airports were only consulted late in the process, the 'bastardised' location-specific pricing model did not form part of Airservices' consultation.

RFDS Queensland Operations (RFDSQ) and RFDS Central Operations (RFDS) noted that although consultation is stated to have commenced in August 2003, most industry members seemed to have been 'caught unawares'. RFDS was unable to comment on the earlier consultation as it was unaware of it happening, however, stated that the process mid this year whilst 'open and frank' was rushed.

6.1.4 ACCC views

The ACCC welcomes Airservices' efforts since its 2003 price notification in moving to develop longer-term pricing arrangements. The formation of the ISC and working group and the level of transparency and consultative approach attested by a number of those involved have enabled those parties to gain a good understanding of the proposal and to raise relevant issues on the aspects of the proposal which are usually controversial issues. The ACCC considers that the ISC and working group should continue to play an integral role in monitoring Airservices' performance against its assumptions and estimates underlying long-term pricing arrangements.

However, the ACCC notes the concern expressed by the majority of Airservices' customers and stakeholders which were not represented in either the ISC or working group. A number of regional and GA operators noted the limited timeframes given to GA operators to respond to Airservices' consultation requests and the limited nature of the consultation afforded to them in relation to the 'final' proposal.

The ACCC acknowledges Airservices' attempts to engage regional and GA stakeholders in the early stages of its consultation process and appreciates the practical difficulties of consulting with a widely dispersed customer base, particularly where that customer base is not represented by any single body and may lack the resources to engage in the process to the extent that the major airlines are able to.

The ACCC considers that it will be important for both Airservices and regional and GA stakeholders to work together to enhance future consultation processes, particularly where proposals are likely to have a significant effect on such stakeholders. In this context, the ACCC considers it important for Airservices to effectively engage its wider customer base and stakeholders, and also for these stakeholders to participate to the extent that they are able, in monitoring and evaluating a long-term pricing arrangement and in deciding how best to respond to any unanticipated events through the life of the pricing arrangement.

Risk-sharing arrangements

6.1.5 Introduction

Given the durable but technical nature of many of the assets employed by Airservices and the uncertainties in forecasting the various demands for Airservices' different services, a number of risks are relevant in establishing long-term pricing arrangements. It is generally desirable and efficient for such risks to be borne by the party to the agreement who is best able (i.e. most efficient) to manage such risks. Risks inherent in a long-term pricing arrangement include:

- 'market' risks, including changes in activity from forecasting errors and unforeseeable exogenous shocks
- risk of supply and operating costs, especially over-runs
- technological obsolescence risks, such as the optimal timing uptake of a new technology
- the risk of changes to government regulation.

6.1.6 Airservices' position

Airservices states that the proposed pricing plan will provide certainty in user charges for the next five years. However, Airservices and the ISC have noted the need to allow for the possibility for prices to be reviewed during the course of the agreement where:

- new regulatory or customer requirements call for a change in service levels which result in a net change in costs
- actual capex as a result of revised priorities and/or timing is anticipated to differ from the forecast level by 50 per cent or more within a single year, or by 25 per cent cumulatively
- activity levels deviate above or below forecast levels by 10 per cent or more within a 60-day period and/or 5 per cent in a financial year. Airservices has subsequently clarified that this relates to aggregate activity levels.

Airservices submits that the above triggers oblige the ISC to consult on the best means for dealing with the impact of the event, which may include the absorption of the cost impact, changes to service levels and/or capital investment programs, or the need for a price adjustment. If a price adjustment is considered to be the appropriate response, then the standard processes will be followed in accordance with the relevant provisions of the Act.[12]

6.1.7 Views of interested parties

The ACCC sought comment from stakeholders and interested parties on the appropriateness of the proposed risk-sharing arrangements embodied in Airservices' proposal. Views were sought in particular on the activity trigger mechanism, the approach taken to changes in Airservices' capex program, and changes in government regulation.

In general there was support for Airservices' proposed risk-sharing arrangements among interested parties. However, a number of specific concerns were raised. Regional and GA operators noted their expectation that Airservices would undertake to consult all affected parties on any proposed changes to its pricing plan. Clarification was also sought as to whether the activity triggers were based on a global or location-specific level. It was also suggested that as Airservices' pricing is based on a per tonne basis, Airservices can effectively shield itself from any risk. A number of interested parties were also of the view that the risk of any cost over-runs should be borne by Airservices.

The ADG, BARA, Qantas, Singapore Airlines and Virgin Blue noted their support for Airservices' risk-sharing arrangements.

BARA submitted that it accepts that the risk-sharing arrangements proposed by Airservices are reasonable, noting that possible pricing adjustments to account for

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[12] Airservices Australia 'Draft price notification—August 2004' p. 5.

large variations in activity levels, capex and changes in government regulation provide an acceptable balance between Airservices and its airline customers in terms of financial outcomes.

Qantas stated that it is not feasible for Airservices to plan its entire proposed capex program with the level of confidence that can be achieved in other industries, therefore, the proposed mechanism to review capex in the event of large variations in the level of capital spend promotes smoother prices over a longer period of time.

Singapore Airlines recognised that factors currently not clear or that are unknown can and probably will impact on the cost of operations during the lifetime of the proposed model. Singapore Airlines stated that it is satisfied that the proposed framework provides for stakeholder consultation, further stating that it is crucial that safety is not compromised. It considered the risk-sharing arrangements acceptable insofar as they provide a measure of security against under servicing.

In addition to their views expressed above, BARA, Qantas, and Singapore Airlines were also of the view that Airservices' risk-sharing arrangements provided a mechanism to ensure that Airservices received a level of funding which would ensure against any under servicing, thereby ensuring that safety would not be compromised.

Virgin Blue is of the view that the risk-sharing arrangements embodied in Airservices' proposed price path are reasonable, stating that it accepted the revision triggers implicit in the proposed price path on the basis that it would reduce Airservices' risk and therefore its required rate of return.

The DPIWA, Gold Coast airport and RVAC stated their general support for Airservices' risk-sharing arrangements provided Airservices undertakes to consult with all affected stakeholders, including GA operators.

In its submission, DPIWA acknowledges the existence of Airservices' risk-sharing arrangements, however, states that there is no detail in regard to the consultation process for any proposed change to service levels or costs.

Cairns Port Authority (Cairns PA) and Mackay PA noted their general support for Airservices' risk-sharing arrangements subject to further clarification as to whether the triggers for activity and capital expenditures would be activated on a network or location-specific basis. Cairns PA considered that it would need to be on a location-specific basis.

Great Barrier Reef airport and Linfox also noted the need for further clarification in relation to Airservices' risk-sharing arrangements. Linfox stated that it is 'very unclear' as to what the risk-sharing arrangements will be, noting that this concept is 'completely vague and lacks substance'. Linfox questioned why Airservices could not undertake some modelling to assess the potential impact in the event that activity levels deviate, or customer requirements change, or if capex was to vary substantially. Further to this, Linfox submitted that Airservices should bear all of the risk of any increase in costs above the levels forecast.

Great Barrier Reef airport noted that there are triggers in place to assess further price rises, but there is no mention of the same triggers applying if forecasted activity is less

than anticipated. Great Barrier Reef airport further noted that forecasting capex over a five-year period is admirable but is very much subject to advances in technology, changing business needs and forecast activity and that major changes in these parameters reducing capital spend must be considered under the same guidelines as any additional capex.

Jandakot Airport CC and the Maroochy SC were of the view that any cost-over runs should be borne solely by Airservices. The Jandakot Airport CC stated that Airservices and its customers should equally share the risks associated with the marketplace, however, it considered that the risks of cost over-runs and technology risk is something that Airservices must be 'wholly responsible' for.

The Maroochy SC noted that any cost over-runs should be borne by Airservices, and that any charges levied due to changes in government regulations should be phased in over a five to 10-year period after a determination has been made on whose responsibility it is to pay.

However, the RFDSW noted that the approach taken to changes in Airservices' capex program appears to include a long-term planning approach and includes an element of consultation and review which should minimise risk with regard to cost over-runs and technology. It was further noted that each of the mechanisms considered would have an impact on the costs for RFDSW with little opportunity for cost control due to the nature of the service provided.

The Mackay PA and Sunshine Express commented on the impact of Airservices' pricing on a per tonne basis on the sharing of risk. Sunshine Express considered that Airservices' basis of charging on a per tonne basis rather than a per passenger basis, as the legislation reads for the establishment of these services, meant that the operator bears 100 per cent of the risk to recoup these costs with the government bearing no risk. Sunshine Express noted that the risk needs to be shared equally between Airservices and the operators which can only be achieved with a per passenger charge.

The RAAA, the RFDS, the RFDSQ, the SMABC and the VRAC do not support the risk-sharing arrangements put forward by Airservices.

RFDS and RFDSQ submitted that it was hard to see how the risk in the longer-term is not borne by industry. SMABC stated that Airservices' submission does not contain any risk sharing on Airservices' part, noting that prices would be reviewed by the ISC, on which GA is inadequately represented. SMABC would feel more comfortable if Airservices had at any point in the submission undertaken to adjust its activities and cost bases to that which reflects more closely the level of activity in the aviation industry.

The RAAA noted that in a proper competitive market, the risk taker would be the shareholders and that if there is a risk to a monopoly provider, that risk should be borne by its 'shareholder' (i.e. the government). It further stated that this is particularly so when the government directs the provision of services which are not justified on economic or safety grounds and which are not requested or required by the customers.

VRAC outlined in its submission its strong objection to a review of pricing within the five-year period, noting that it was Airservices' choice to move to the five-year plan and therefore it must be its risk to stick to prices set out for that period.

The Maroochy SC recommended that six-monthly reviews be carried out for the Sunshine Coast airport as it is currently experiencing rapid growth, well ahead of that stated in Airservices' model.

Rockhampton CC stated in its submission that to date it had not received any proposed risk-sharing offers, either related to capex or operational expenses from Airservices. It further noted that it made a verbal offer to enter into a risk-sharing relationship in relation to capex.

6.1.8 ACCC views

In the past Airservices has taken a short-term approach to setting its prices, adjusting prices to reflect changes in market conditions. As a result, Airservices has not exposed itself to the risks associated with changes in activity levels, capex and/or government regulations.

This is true for both upside and downside risks; for example, in support of its 2002 price notification, Airservices supported its claim that it does not act like a profit-maximising monopolist by reference to the fact that it had not increased its charges for a number of years, but rather had reduced its charges in real terms by more than 20 per cent between 1998–89 and 2001–02.

In 2003 the ACCC considered that a long-term approach to pricing would provide for a better sharing of risk between Airservices and its customers. In particular, it was noted that Airservices should bear more risk in relation to the management of costs and changes in activity than it otherwise would have under a short-term pricing arrangement.

The ACCC considered in 2003 that exposure to the risk of cost over-runs and the variability in activity is an important discipline on management decisions over the timing and extent of new investments. This would also have the effect of leading to more stable prices over time.

The ACCC considered that a long-term pricing arrangement in which Airservices bore the risk of cost over-runs, particularly in relation to its capex program, would strengthen the incentives on Airservices to rigorously assess the value of an investment, countering the incentive to over invest which is inherent in a short-term pricing arrangement in which the cost of investment can simply be re-couped through higher prices.

The risk-sharing arrangements embodied in the long-term pricing arrangement proposed by Airservices are not prescriptive, but rather include a number of trigger points, the meeting of which obliges Airservices to consult the ISC on the best means of dealing with the impact of the event. It is therefore unclear what the resulting sharing of risks will be in practice. This is because the consultation process may result in one of a number of possible responses to risk. For example, Airservices may absorb

reductions in revenue arising from a reduction in activity, or it may seek to increase prices.

The ACCC notes that, while there is a diversity of opinion on this issue, there appears to be broad acceptance of the proposed arrangements by a substantial proportion of interested parties. However, a number of stakeholders qualified their acceptance of the arrangements by submitting that the consultation process should include a wider group of interested parties than have been represented on the ISC to date. This applies in particular to the smaller users.

In addition, in relation to Airservices' capex program, the ACCC notes that a number of elements of that program rely on user uptake of enabling technology and/or may involve cost savings to customers, giving users a much stronger interest and influence on those elements of Airservices' capex program.

The ACCC therefore considers that the proposed trigger arrangements may provide the opportunity for Airservices and its customers to examine the appropriate response to particular circumstances impacting on Airservices' profit, taking into account which party is best placed to respond to, or absorb the effect of particular circumstances. However, the ACCC supports the point made by those respondents which considered that the consultation process should encompass a wider group of Airservices' stakeholders than the representatives of the ISC. The ACCC encourages Airservices, along with its customers, to examine the practicalities of how to undertake this consultation.

In addition, it appears to the ACCC that there may be merit in Airservices and particular airports entering into individual risk-sharing arrangements. Airports which are most likely to benefit from this type of arrangement are the smaller regional airports where significant change in activity is expected.

For example, Airservices could enter into an agreement (with any revenues or losses not being taken into account in assessing the revenue underlying future price notifications) with a particular airport in relation to the activity rates at that airport for the five-year period. The parties could agree, for example, that if activity is greater than the levels underlying Airservices' pricing proposal, Airservices would share the increase in revenue with the other party in the agreed proportions. Similarly, if activity is less than the levels underlying Airservices' pricing proposal, Airservices would be able to recoup an agreed proportion of its associated losses in revenue from the other party. This could allow for particular airports to have an incentive to grow traffic at their airport because it could result in lower average costs for flights at their airport.

The inclusion of trigger mechanisms in Airservices' proposal make it unclear to the ACCC whether Airservices is taking on any additional level of risk than it has in the past. As mentioned by Virgin Blue, the manner in which various risks are taken into account is relevant to the rate of return that is appropriate to allow Airservices. This point is considered in the rate of return section of this document.

Conclusion

In past Airservices' decisions the ACCC has strongly encouraged Airservices to adopt a longer-term view of establishing prices. Therefore Airservices' proposal for a five-year pricing plan is welcomed. Similarly, the ACCC considers that the approach Airservices has taken in setting up consultative industry arrangements has been positive. It has improved the degree of transparency of its operations and allowed for detailed consultation on a number of usually contentious issues. However, as evidenced by a large number of submissions, the degree to which general and regional aviation customers and some other stakeholders have been involved has been less than ideal. The ACCC encourages Airservices and its customers to address this situation in the arrangements for further development of Airservices' pricing and for monitoring its performance during the five-year pricing arrangement.

While Airservices' customers may have more certainty in the costs they face from Airservices' charges than they have in the past, it is unclear to the ACCC whether Airservices will be exposed to more risk under a five-year pricing arrangement than it has been in the past. However, the ACCC notes the substantial degree of support for these arrangements from most interested parties. It is expected that Airservices will expand its efforts to engage its wider customer and stakeholder base for considering appropriate responses to factors impacting on Airservices' necessary commercial performance. The ACCC also encourages Airservices to consider entering into individual risk-sharing arrangements with interested parties.

7 Building block methodology

Introduction

The building block methodology is used by the ACCC as a regulatory tool to assess the revenue required by a firm to provide a regulated service and is applied by the ACCC across a number of regulated industries. The building block model's focus on efficiency of costs and the generation of a reasonable rate of return assists the ACCC in assessing whether a declared company may have used its market power to set prices above efficient levels. A cost-based building block approach is based on the following expected efficient costs which together form the allowable revenue:

- operating and maintenance expenditure
- a rate of return on the firm's asset base, including an adjustment for tax liability
- depreciation of the asset base (also referred to as the return of capital).

Return on capital is defined as the value of a firm's asset base multiplied by its WACC. The value of the asset base at the start of each period is equal to the closing value of the asset base in the previous period, less depreciation and adding capex.

Table 7.1 below sets out the components of the building blocks in Airservices' proposal, together with the proportion of total revenue for each element.

Table 7.1 Airservices' proposed building blocks ($million)

	2004–05	2005–06	2006–07	2007–08	2008–09	Total	% of revenue
Return on assets	39	43.1	46.9	49.5	51.4	229.9	7.08%
Total OPEX (excl dep)	482.4	507.7	519.7	538.6	555.8	2604.2	80.19%
Depreciation	77.1	74.4	76.8	78.6	78.3	385.2	11.86%
Tax	4.8	5.3	5.8	6.1	6.3	28.3	0.87%
Revenue	**603.3**	**630.5**	**649.2**	**672.8**	**691.8**	**3247.6**	**100%**

As illustrated in Table 7.1, operating expenditure is the major component of Airservices' business, (making up about 80 per cent of Airservices' proposed allowable revenue) and the return on capital is relatively small (making up only about 7 per cent of Airservices' allowable revenue). Therefore, relatively small changes in Airservices' return on capital are unlikely to have a significant impact on its total revenue requirement and ultimately the end price of its services.

A feature of the building block model is that, putting aside any rewards or penalties associated with financial incentives, provided the model is consistently applied in the

long term, and provided the regulator correctly estimates the firm's true cost of capital, the regulated firm will always receive a stream of revenues which is equal, in present value, to the stream of its expenditures.[13]

In determining each building block, the ACCC balances Airservices' need to generate a fair and reasonable return while at the same time promoting the efficient provision of services.

The following sections outline in detail each of the building block components along with Airservices' position, the views of interested parties and the ACCC's considerations.

Operating costs and maintenance expenditure

7.1.1 Introduction

Operating and maintenance costs play a critical role in determining the required revenue for a declared service. As a result, the efficiency with which those costs are incurred is a key consideration for the ACCC. This is particularly true for Airservices, which has a significantly higher proportion of operating and maintenance costs as compared with other regulated monopolies. This arises in large measure from the mix of both capital-intensive infrastructure assets (such as en route navigation facilities) and the labour-intensive services provided for the safe use of many of those assets (such as air traffic control).

Airservices embarked on a five-year business transformation (BT) process in 1997–98, which aimed to reduce the real prices of its services by 20 per cent, cut costs by $100 million and double profitability within five years. These objectives were achieved two years early and the real prices of its services declined on average by 6.4 per cent each year from the commencement of BT until 2002–03, when real prices increased by 0.7 per cent.[14]

In its 2003 decision the ACCC concluded that it was unable to make an assessment that Airservices was operating and incurring costs at efficient levels. This was notwithstanding a recognition of Airservices' cost mitigation strategies and reductions in certain costs. The ACCC also took into account the absence of an efficiency incentive mechanism in Airservices' pricing structure that would encourage it to reduce costs.

The ACCC encouraged Airservices to undertake independent and reviewable benchmarking studies with commercially oriented air traffic managers to help clarify the relative international efficiency of its operations. The ACCC also suggested that total factor productivity (TFP) techniques may provide insights into Airservices' efficiency performance, especially trends over time. The ACCC also identified that

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[13] ACCC draft decision, 'Statement of principles for the regulation of electricity transmission revenues', Background paper, August 2004, p. 18.

[14] Airservices' preliminary pricing proposal to the ACCC, 31 March 2003, p. 7.

efficiency measures could and should be built into Airservices' pricing structure and one mechanism to achieve this would be through a longer-term pricing approach.

7.1.2 Airservices' position

Airservices provided additional information to the ACCC which showed that its opex[15] fell by an average of 4 per cent per year from $466.8 million to $448.2 million over the five-year period to June 2004. However, the pattern of cost movements varied substantially over this period, with average annual reductions in opex of 10 per cent in 2000–01 and in 2001–02, followed by annual increases of 10 per cent and 7 per cent respectively in 2002–03 and 2003–04.

Airservices states that in 2004–05 operating costs are expected to increase by $34.2 million or 7.6 per cent, mainly reflecting:

- increases in staff costs (of $17.7 million) and supplier costs (of $2.8 million) (totalling $20.5 million)
- regulatory changes for ARFF services that require upgrades to services at some locations ($6.6 million)
- new ARFF services planned or recently established at Ayers Rock, Maroochydore and Townsville ($5.7 million)
- additional ATC training requirements ($3.9 million)
- a $2.5 million reduction in annual repair and maintenance costs in accordance with an independent review of these costs following the adoption of an ODRC asset valuation.

Airservices submits that, after applying a dual till methodology, the operating and maintenance-related costs reflect the cost of providing the regulated services only. Airservices states that its five-year operating cost projection was developed in consultation with the ISC to reflect:

- statutory obligations in relation to safety
- the cost of providing baseline services
- the impact of the capital investment program
- the projected effect of the regulatory changes in the provision of ARFF services
- continuing productivity improvements.

Airservices submits that its operating costs have been reviewed by the ISC.

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[15] As is conventional, depreciation charges have been excluded from this discussion of operating costs and are considered in the asset base section of the report.

Airservices states that GA and regional users expressed concerns with the overall affordability of proposed price increases and that as a monopoly provider there were few incentives for Airservices to operate efficiently. However, Airservices argues that these concerns should be ameliorated to a large extent by the targeting of a lower WACC and a proposal that offers affordable prices.

Airservices states that it will continue to review the ongoing requirement for a number of towers (including their operating hours), that are considered 'marginal'.

In additional information provided to the ACCC, Airservices argues that its profitability is highly sensitive to changes in operating costs. Airservices claims that if operating costs rise or fall by 1 per cent, its profit after tax falls or rises by 10 per cent. Airservices also argues that, as part of the development of its long-term pricing proposal, it has had to balance operating cost risks against productivity targets. Airservices further argues that it would not have been able to commit to the efficiency targets implicit in the funding proposal if key operating cost increases related to pay rises, training requirements for additional services and superannuation were not covered.

7.1.3 Views of interested parties

The ACCC's issues paper sought comment from interested parties on the level of estimated operating costs reflected in Airservices' proposal and Airservices' incentives and effectiveness in containing and reducing these costs.

There were significant differences in the responses of parties to these issues. Airservices' major customers and their representatives were generally supportive of the approach adopted by Airservices in relation to operating costs, while other parties generally raised concerns about the efficiency of Airservices' operating costs.

BARA, BA, IATA and Qantas identified their support, with some qualifications, to Airservices' approach to operating costs. However, BARA and Qantas both noted that it was difficult to assess the current efficiency of Airservices' costs. Virgin Blue indicated that it was not satisfied that Airservices' operating costs were efficient, but nonetheless did consider that the pricing proposal provided incentives for Airservices to reduce costs and increase efficiency.

BARA submitted that it was generally accepted that:

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

Further, BARA submitted that the discipline imposed by a longer-term pricing arrangement gave airline representatives some comfort that there will be an ongoing

trend for Airservices' costs to be more efficiently incurred in the future. BARA also noted that Airservices has also given an undertaking that it will engage in ongoing consultations with the industry about its cost base.

Qantas submitted that, while it is difficult to completely satisfy itself there were no further efficiencies to be extracted, Airservices had provided all financial and operational data requested by users as part of the consultation process. Qantas also noted that although the increases in costs appeared high, some of the cost increases were necessary to support planned increases in service levels attributable to regulatory change (such as new fire stations and increases in ARFF categories), or the service expectations of users, such as user preferred routes and flexible use of airspace.

Further, Qantas submitted that by developing a known price path, Airservices will have strong incentives to manage its costs efficiently. The pricing arrangement rewards Airservices for efficient management of its costs.

Qantas also submits that, with defined service levels and commitments to consultation, there are adequate avenues for Airservices to demonstrate that it has not sought higher profits by reducing service standards.

BA submitted that, although the ACCC noted that increases in Airservices' costs were apparently high, there is significant investment required by Airservices to deliver planned increases in service levels in areas such as user preferred routes and flexible use of airspace. BA further contends that the price path is set at a level that should provide Airservices with strong incentives to manage its costs efficiently. BA also notes that the importance of Airservices agreeing to provide defined service levels, together with Airservices' commitment to consultations with airline representatives, provide appropriate safeguards against reductions in quality of service.

IATA agreed with Airservices' forecast costs by service and location.

Virgin Blue submits that it is not satisfied that Airservices' proposed operating costs represent efficient (or even reasonable) costs in an overall sense. Virgin Blue claims that Airservices was not able to provide sufficiently detailed information to justify the substantial increases in operating costs for the initial year of the price path.

In particular, Virgin Blue considers that Airservices' superannuation arrangements are overly generous relatively to a purely commercial organisation and above an efficient payment level.

According to Virgin Blue, information provided to it by Airservices suggests that on costs (which primarily consists of superannuation) are forecast to increase from $40.6 million in 2003–04 to $59.5 million in 2008–09. This, according to Virgin Blue, confirms that superannuation is a material expense item and an essential consideration in the context of the reasonableness of Airservices' operating costs.

However, Virgin Blue submits that a long-term pricing plan should provide Airservices with an incentive to reduce costs and increase efficiency. Further, Virgin Blue contends that a long-term pricing model would create greater certainty for Virgin Blue's planning and forecasting, particularly in relation to the addition of capacity

and/or frequency on existing routes and the commencement of new flights on new routes.

Adelaide airport and Canberra airport also indicated it was difficult to make an assessment about the efficiency of Airservices' operating costs.

Adelaide airport noted that there was insufficient transparency regarding Airservices' operating costs and in particular its headquarter charges. Adelaide airport remarked that it seemed strange that the costs of operating a tower at Parafield 'is almost more than double the cost of running the whole rest of the airfield'.

DPIWA, GAM, Gold Coast airport, Great Barrier Reef airport, Linfox and Mackay PA raised a number of issues related to the efficiency of Airservices' staff costs.

DPIWA contends that because Airservices is a monopoly service provider for TN services in Australia, it would be appropriate for Airservices to demonstrate some comparable benchmarking to similar service providers in other countries.

GAM states that staff costs make up 37.5 per cent of the total cost of providing TN, and an average figure of $187,395 per staff member has been used to calculate a total staff cost of $89.5 million. GAM considered that these staff costs seemed excessive.

Gold Coast airport argued that Airservices' costs are not truly representative of the value of the service provided, and are the result of inefficiencies, particularly in the number of staff employed in the non-operational and management areas, often endemic in an organisation where there is no financial incentive to its employees to be more efficient.

Great Barrier Reef airport notes that their staff costs are expected to increase from 51 to 62 per cent of operational costs in the 2005–06 period, while Great Barrier Reef airport itself expects activity to remain relatively constant.

Great Barrier Reef airport contends that this does not indicate an attempt by Airservices to contain costs. If the data that had been put forward by Great Barrier Reef airport regarding future movements at the airport had been considered on its merits, then it considered that 'we would not be seeing the cost for the proposed additional staff member in the Airservices' profit and loss statement from the 2005–06 period onwards.'

Linfox argues that Airservices' charge of $200,000 per person for Air Traffic Control (at Essendon airport) is offensive to the industry. According to Linfox, this indicates a long-term habit of losing control of staff costs and then monopolistically ordering the industry to pay for these excessive amounts. It is likely that these heavy costs include substantial defined benefit superannuation arrangements that must also be borne by the industry.

Mackay PA argues that that, while Airservices claims that it has reduced costs over recent years, the costs of providing ARFF and tower services at Mackay airport has continually increased. Mackay PA also states that it has not identified any cost reduction measures implemented at Mackay airport for ARFF and tower services.

SFC submitted that Airservices should examine more cost effective methods of providing ARFF services; for example, by combing ARFF services at GA airports with local fire services, which it submitted would substantially reduce costs without impacting on the quality of service delivery.

Gold Coast airport and Mackay PA suggest that Airservices should be subject to competition in the supply of air traffic control and ARFF services.

Gold Coast airport claims that the estimated costs in the proposal are excessive and that a competitive environment would substantially reduce the costs of supplying air traffic control and ARFF services.

Mackay PA states that the only way to test Airservices' cost structure is to invite tenders for contracting out these services in the open market.

In contrast, Archerfield airport, Maroochy SC and RFDSW indicated that, with some qualifications, Airservices' operating costs were set at reasonable levels.

Archerfield airport noted that Airservices had made a local effort to try and relieve some of the pressures of providing a tower that does not 'earn its keep' and stated that, from an Airservices' perspective, its operations are very much kept to the minimum. Archerfield airport, however, also suggests that further cost reductions could be achieved if there were more flexibility with tower hours.

Maroochy SC submits that Airservices' level of operating costs appears to be satisfactory. However, it is concerned about the distribution of those costs.

RFDSW submits that Airservices' services are efficiently provided and that the significant increase in costs in 2004–05 is justified by the addition of new and upgraded services and increased depreciation arising from the revaluation of assets. However, it is unclear to RFDSW why there is no acknowledgement of efficiencies arising from new investments such as the implementation of the ADS-B technology.

Cairns PA, Jandakot Airport CC and the SFC raised issues regarding efficiency incentive mechanisms in Airservices' pricing proposal.

Cairns PA argues that under any location-specific pricing mechanism there needs to be productivity measures and targets set that take into account the size and scope of an airport, the potential growth in activity at the airport, and that the operating costs of the airport should be assessed against location-specific measures.

Jandakot Airport CC suggests that the ACCC ties in any approval of a new Airservices' pricing regime with a strong mechanism that enforces a culture of cost control by setting quantitative targets; i.e. 20 per cent of the total cost base must be under review at all times; active programs must identify a minimum of 5 per cent of the cost base each year; and 50 per cent of all active programs must yield full cost savings. It is argued that this system will result in a 2.5 per cent reduction in Airservices' costs each year and that monitoring must be quarterly 'and would be akin to IMF monitoring'.

SFC contended that there is very little incentive in the present proposal for Airservices to reduce costs, or to seek a more efficient means of service delivery.

Further to this, SFC submitted that while Automatic Dependent Surveillance Broadcast (ADSB) technology is due to replace en route radar services by the end of 2008, resulting in considerable cost savings, it did not see how these savings would be passed on to customers, if at all.

Other submissions addressing the issue of operating costs were also received from ADG, RVAC and SMABC.

ADG noted that Airservices' payment of peppercorn rentals does not represent market reality and therefore leads to inefficiency within the organisation as a real cost is hidden. ADG recommends that Airservices reviews its costs to include market values for land that it leases and commence paying the same. However, ADG notes that Airservices has achieved efficiency gains over the past few years and that continues to be a focus of the organisation.

RVAC identified that it was unable to adequately comment on the overall level of Airservices' operating costs, or its ability to contain or reduce the overall level of costs. However, RVAC notes that staff costs and total operating expenses of the tower at Moorabbin are forecast to rise over the five-year period by only 16 per cent, while charges proposed on tower usage are to rise by 71 per cent.

SMABC argued that it is not possible for Airservices to 'break even' in regard to costs and revenues at Bankstown and Camden airports. SMABC submits that Airservices should consult with the GA industry to see if there are ways by which appropriate levels of safety can be achieved by other means at significantly lower cost to Airservices and the GA industry. SMABC also argues that where government or Airservices' policy supports the retention of otherwise uneconomic facilities, such services should be subsidised by other Airservices' revenues or by the government.

7.1.4 ACCC views

The ACCC notes that Airservices' draft price notification does not contain any specific information that would enable an assessment to be made as to whether Airservices is operating at efficient levels. The proposal also lacks any formal and explicit efficiency mechanism.

The ACCC notes that the ISC considered that a formal TFP study of the efficiency of Airservices' operations was not required and its major focus has been on analysing the efficiency of Airservices' cost base.

Airservices' draft price notification also does not provide any detailed information identifying the separate impact of its proposed capex program on its operating and maintenance costs. The ACCC has, however, received some additional information from Airservices which suggests that, while the capex program will generate savings in some areas, overall it is expected to have only a minor impact on operating expenses. Airservices has identified a number of reasons why its proposed capex program will not lead to a reduction in maintenance costs and in some circumstances may actually contribute to increased maintenance costs.

As the ACCC noted in its 2003 decision, users have a strong interest in being provided with additional information that identifies how future savings associated

with the purchase of new capital equipment are being reflected in Airservices' cost structure. The ACCC therefore encourages Airservices to increase the level of information provided to its users on this issue.

The ACCC has identified three major issues associated with the operating cost estimates in the pricing proposal, which are also reflected in public submissions. These relate to:

- the significant increase in Airservices' operating cost estimates in 2004–05
- the proposed increases in staff costs over the five-year period to June 2009
- the efficiency incentive mechanisms indicated in the pricing proposal to contain and reduce operating costs.

(a) Increases in operational expenditure in 2004–05

Airservices' draft price notification identifies a $34.2 million or 7.6 per cent annual increase in operational expenditure during 2004–05, over 2003–04. Operational expenses are forecast to increase by smaller amounts over the period 2005–06 to 2008–09, with average annual nominal increases of 3.6 per cent, ranging from 2.4 per cent in 2006–07 to 5.3 per cent in 2005–06.

The ACCC notes Virgin Blue's comments that Airservices has not provided sufficiently detailed information to justify the substantial increases in operating costs for the initial year of the price path, particularly in relation to its increases in superannuation contributions. The ACCC, however, also notes comments from BARA and Qantas that Airservices has provided all financial and operational data requested by users as part of the consultation process.

Excluding the impact of increases in operational expenses resulting from regulatory change for upgraded ARFF services and the requirement for new ARFF services, and pay increases (which is considered below), additional superannuation contributions is the most significant item explaining the forecast increase in operational expenses in 2004–05. It alone accounts for 20 per cent of the annual increase in operational expenditure in 2004–05.

Airservices has advised the ACCC that its superannuation arrangements are similar to other large commercial organisations, including those within the aviation industry. Airservices also identifies that its two defined benefit funds (DBFs) have been closed to new staff (since 2002) and replaced with accumulation funds. According to Airservices, it has examined options to transfer existing DBF employees to accumulation funds but has received advice that such a move would be likely to increase Airservices' superannuation costs.

The ACCC recognises that increases in employer liability for superannuation contributions are a major factor contributing to increases in Airservices' operational expenditure in 2004–05, but does not consider that the increased costs are necessarily above an efficient payment level. The ACCC also notes that, while Airservices may bear a greater degree of risk associated with its DBFs, it has closed this option to staff

and has investigated the costs and benefits of transferring employees out of DBFs. It has advised that its estimated contributions for 2004–5 are based on actuarial advice.

Overall, the ACCC considers that the proposed increases in superannuation expenses in 2004-05 are reasonable.

(b) Increases in staff costs

The ACCC considers that there are a number of factors affecting the efficiency of Airservices' staff costs over the five-year period to June 2009. These include existing salary levels for Airservices' staff, allowances for increases in wage levels, the level of salary oncosts, increases in staffing levels and increased employer superannuation contributions (discussed above).

Salaries and allowances and oncosts are the two major components of Airservices' staff costs, accounting respectively for an average of 71 per cent and 25 per cent of total staff costs over the five-year period.

Airservices currently employs 2848 staff, with air traffic control and ARFF staff accounting for 1765 or 62 per cent of Airservices' total staff and 66 per cent of Airservices' salary related payments to staff.

Airservices has advised the ACCC that air traffic controller annual salaries currently range from a base of $61 671 to $125 503, depending on location, experience and responsibility. Team leaders (with staff training and management responsibilities) receive annual salaries ranging from $114 445 to $138 053, depending on location.

The ACCC notes that average staff costs at Essendon airport are significantly higher than average staff costs at other regional and GA airports. Airservices has advised the ACCC that the major reason for this is that Essendon ATCs operate in a radar environment and are therefore paid at the same salary rate as ATCs in other radar locations.

Other information provided to the ACCC by Airservices (and discussed in the basin pricing section of this document) suggests that the radar approach service provided from Essendon airport is mainly used by aircraft landing at Melbourne airport, rather than at Essendon airport, which would suggest that the increased staff costs associated with providing radar services at Essendon airport should be targeted to users of Melbourne airport rather than Essendon airport. However, the revenue Airservices is proposing to recover from Essendon airport (as a result of the basin pricing approach) is significantly less than the estimated costs, even when account is taken of the high staff costs at Essendon airport.

Airservices has provided the ACCC with some confidential benchmarking studies carried out by a third party which compare remuneration levels of air traffic controllers in Australia with those in a number of other countries. The benchmarking studies suggest that remuneration levels for ATCs in Australia are not currently set above international benchmark levels.

The annual salaries of ARFF staff currently range from $22 651 for a recruit fire fighter, $54 904 for a leading fire fighter, and up $66 337 for a fire commander.

Airservices provided the ACCC with some internal benchmarking studies of Airservices' ARFF services. This information does not suggest that Airservices' staff resourcing for this function is excessive, compared with resourcing levels applied to airport fire-fighting in Europe, the UK and the USA.

As identified in the ACCC's 2003 decision, the ACCC would need to be provided with more detailed and independent information than is contained in the above benchmarking studies to make an assessment as to whether or not Airservices is operating at efficient levels. Nonetheless, the above benchmarking studies do not suggest that Airservices' resourcing of its air traffic control and ARFF staff is necessarily above international levels.

Airservices' certified agreement for 2002-2005 provides for a 4 per cent wage increase to its staff in 2004–05. Airservices has also provided the ACCC with some confidential estimates of increases in wage levels over the five-year period 2004–05 to 2008–09. The ACCC has assessed these estimates of future wage increases and does not consider them to be unreasonable.

Airservices has provided information to the ACCC which indicates that its overall staff numbers are forecast to increase by 102 (or 3.6 per cent) over the five years to June 2009, mainly as a result of the establishment of new and upgraded ARFF services.

The ACCC understands that an additional 123 staff will be required to satisfy the Civil Aviation Safety Authority (CASA) regulatory requirements for staffing of ARFF services. Airservices has also advised that the age profile of its maintenance staff indicates that a number of these staff will retire over the next five years. Airservices has indicated that, to provide the current level of service to its customers, it is proposing to recruit and train an additional 13 maintenance staff over the period 2004–05 to 2008–09.

Partly offsetting these increases in staff numbers, Airservices has advised the ACCC that it expects to reduce its staffing in other areas by 34 staff members over the period of the pricing proposal.

Overall, the ACCC is prepared to accept that Airservices' proposed increases in staff numbers and costs are not unreasonable.

(c) Incentive mechanisms

Airservices' pricing proposal does not contain any formal or explicit incentives on it to minimise opex, such as would be the case if, for example, Airservices' pricing was subject to a CPI–X price cap. Under a CPI–X price cap methodology, a regulated firm may be permitted to increase its average charges by the rate of inflation less a productivity efficiency factor ('X'). The regulated firm is thus able to earn a higher rate of return if it reduces costs below the forecast rate of productivity growth (the X factor), while users of the regulated business also benefit from cost reductions from expected productivity growth being passed on and reflected in prices.

For example, in the United Kingdom, National Air Traffic Services (NATS), the provider of ATC services, is subject to price caps. The NATS price cap is reviewed every five years, which provides an incentive for it to make efficiency gains and also allows those gains to be shared with customers. Although RPI minus X forms the basis of charge control, certain other adjustments are also made; in particular, a quality of service factor is designed to take account of the extent to which NATS is successful in reducing delays to service users.

The ACCC notes that respondent views differed as to whether Airservices' pricing proposal provided adequate incentives to contain and reduce costs. Airlines in particular have been supportive of the incentive mechanisms which they claim are contained in Airservices' pricing proposal. Qantas argues that a long-term pricing path provides Airservices with strong incentives to manage its costs efficiently. In addition, these respondents state that Airservices has agreed to quality of service controls which they consider will ensure that quality of service is not compromised.

In contrast, a number of organisations questioned the efficiency of the current level of resources deployed by Airservices and argued that the proposal provides no financial incentive for Airservices and its employees to be more efficient. In addition, Gold Coast airport and MPA considered that competitive pressures are needed to reduce Airservices' costs.

The ACCC considers that Airservices has made attempts to improve the level of transparency about costs incurred by it in providing services to its customers and that Airservices' long-term pricing proposal may provide a number of benefits to customers, through scope for a better sharing of risks and more stable prices over time.

The ACCC also considers that Airservices' pricing proposal represents the first steps towards introducing a formal incentive to reduce costs by making transparent Airservices' cost estimates for the next five years and specifying prices. The ACCC considers that this will provide an incentive for Airservices to reduce its costs below its forecasts.

The ACCC considers that there are benefits in formal efficiency incentives which make transparent any gains in efficiency. The ACCC encourages Airservices to consider introducing initiatives such as a CPI–X price cap in future long-term pricing proposals to be considered by the ACCC.

(d) Conclusion

The information provided by Airservices does not fully enable the ACCC to make an assessment as to whether Airservices is currently operating at efficient levels. However, the limited benchmarking information provided to the ACCC and submissions from Airservices' major customers lead the ACCC to accept the proposed levels of operational expenses for the purposes of this price notification.

The ACCC considers that the proposed increases in operating expenses, in particular resulting from regulatory requirements and from increased wages and superannuation contributions, are reasonable. In addition, the long-term pricing model contains some incentive properties for reductions in operating expenses and will provide a

benchmark against which its customers can assess Airservices' performance throughout the long-term pricing agreement. The ACCC considers that Airservices could further develop these efficiency incentives in future pricing proposals.

Asset base

7.1.5 Introduction

In the building block model, the value of assets is fundamental to the calculation of the allowance for both the return on capital and depreciation. However, as stated in the introduction to this section of the document, the relative size of the return on capital component of Airservices' allowable revenue is very small and thus forms only a minor part of the ACCC's assessment of Airservices' pricing proposal.

The ACCC has previously indicated a preference for Airservices to apply the optimised depreciated replacement cost (ODRC or DORC) approach to valuing its assets. The DORC approach has the advantage of minimising significant shocks to price and implies levels of pricing that provide only revenues sufficient to cover efficient costs.

The initial valuation of the asset base is a crucial factor in determining the allowable revenue under the building block approach. Where the initial asset base is valued incorrectly, the potential arises for the firm to over- or under-recover its capital investment and return on capital, with corresponding implications for investment incentives in the future.

In its 2003 decision the ACCC expressed concern over the quality of information and level of detail present in the asset valuation report that was provided by Airservices. The ACCC also expressed concerns over the level of analysis on the optimal level of assets that Airservices should hold. The ACCC urged Airservices to undertake further analytical work on the value of its assets.

7.1.6 Airservices' position

During its consultation process, Airservices and the ISC mutually agreed on an independent consultant, Hymans, to provide valuation advice on Airservices' current asset base (including an ODRC valuation) and a close examination of the material movements in individual asset values.[16] Hymans' total asset valuation for Airservices, as at September 2003, is $338 million, an increase in the value of assets of $41.7 million. In January 2004, the ISC supported Hymans' total asset valuation.

The $41.7 million represents a 14 per cent increase in the asset base, primarily reflecting the reversal of a one-off asset write down in 1999 of almost $100 million to reduce the value of assets at loss making locations to zero in accordance with accounting standards. The write down also took into account a reduction in the lives of a number of assets which were anticipated to be made redundant due to changes in technology.[17] The Hymans' report noted that the reason behind the reversal of write

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[16] Airservices' long-term pricing consultation meeting—minutes, Wednesday, 27 August 2003.

[17] Airservices' draft price notification, August 2004, p. 16.

downs is that the ongoing maintenance program is supporting the equipment to extend the total economic life and therefore the assets' worth. It was further noted that the re-valuing of these assets and the resulting depreciation change is aimed at minimising the saw tooth effect of nil depreciation of fully depreciated assets followed by the recommencement of depreciation of newly capitalised assets.[18]

Based on information provided to the ACCC, Airservices has employed straight line depreciation in its current pricing proposal and freehold land has been treated as a non-depreciable asset. Airservices submits that the revaluation of assets (mainly the write back of loss making assets) and investment in new facilities will increase depreciation by $22.9m (in 2004–05).[19]

7.1.7 Views of interested parties

The ACCC sought comment from interested parties on the efficiency of Airservices' asset base, the appropriateness of Airservices' new values for its asset base and the appropriateness of revaluing assets which previously had a zero written down book value.

There was a general consensus from those stakeholders involved in the ISC that they were willing to accept the value of the asset base as put forward by Airservices. However, some stakeholders noted that their acceptance was subject to certain conditions. In addition, there was a general concern amongst a number of regional and GA operators who considered it inappropriate for Airservices to revalue those assets which previously had a zero written down book value.

IATA, Cathay Pacific, Emirates and Maroochy SC submitted that they agreed with Airservices' outcomes relating to the capital value of existing assets.

The ADG stated that it was supportive of the building block approach used by Airservices to determine charges and in particular supported the use of DORC in determining asset values.

BARA, Cairns PA and Qantas noted their acceptance of Airservices' asset base subject to certain conditions.

BARA stated that given that Airservices had been requested to re-value its assets and that the ACCC favours a DORC methodology for asset valuation, it was willing to accept the value of Airservices' asset base as contained in the draft price notification and the revaluation of assets that previously had a zero written down book value. However, BARA submitted that its acceptance of Airservices' asset valuation was subject to the following conditions:

- acceptance by Airservices that its asset base for pricing purposes is now defined and further revaluations for pricing purposes will not be required

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[18] Airservices Australia 'Hymans report and valuation December 2003' pg 2

[19] Airservices' draft price notification, August 2004, pg 24.

- Airservices abiding by its commitment to update its asset base according to actual capital expenditures, depreciation and asset disposals

- Airservices providing the above information to airline customers on an annual basis.

BARA noted that the above considerations are an important aspect of the airlines' acceptance of the pricing proposal and are fundamental to ensuring that any large and unpredictable increases to airlines' cost structures are either avoided or minimised.

Qantas submitted that it does not support the application of asset valuation methodologies such as DORC in setting prices, however, it recognised that Airservices was requested to value its assets as part of the consultation process and does not object to the value determined by the consultant. However, Qantas noted that while it continued to oppose the use of DORC valuations for pricing purposes it was of the view that now that a regulatory asset base for pricing purposes has been established, further revaluations for pricing purposes were no longer necessary and that going forward, Airservices would continue to track and update its asset base based on actual capex, depreciation and disposal of assets.

Cairns PA stated that it accepts that Airservices should be entitled to earn a return on all assets employed in the provision of its services and therefore it may be appropriate for Airservices to revalue assets to fair value at the commencement of the modelling period, but only to the extent that such assets are currently fully utilised in the provision of the services. However, it considered that it would not be appropriate for any further revaluations to be brought to account in the modelling.

Virgin Blue stated that, in the spirit of completing the review process within a reasonable time, it accepted various valuation simplifications that may have skewed the results more favourably towards Airservices. It noted that while it is dubious for a monopoly service provider to receive a rate of 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 Airservices.

Gold Coast airport, Jandakot Airport CC, Mackay PA, RFDSW, RVAC, SMABC and VRAC expressed their concerns as to the appropriateness of Airservices' revaluing assets which previously had a zero written down book value.

Gold Coast airport submitted that where 'original cost' has been fully depreciated and therefore already recovered as part of the charges levied, it is not acceptable that Airservices seeks to revalue these assets and subsequently allocate further amortisation costs for recovery through additional charges. It further noted that any efficiency which results due to the previous higher amortisation should be passed through to users as opposed to an adjustment to the equity balance of Airservices.

The Jandakot Airport CC is of the view that Airservices' asset base has been over valued in disregard of generally accepted accounting principles and would appear to have been bloated out on the basis of trying to enhance the balance sheet. It noted that written down assets that have already been paid for by users through Airservices' charges, and in the past fuel levies and taxation, have been re-valued and the higher depreciation rates used by Airservices to justify its higher cost base. The Jandakot

Airport CC further stated that, as a start, Airservices' asset base should be reduced by circa $42 million (i.e. the increase in value arising from the DORC revaluation) to bring it into line with generally accepted accounting principles.

Mackay PA submitted that it did not have sufficient information to make a determination on the validity or appropriateness of Airservices' revaluation model. However, it stated that the revaluing of previously written down assets further exacerbates the large increases in charges at regional airports.

RFDSW also questioned the validity of Airservices reversing a write-down of five years ago which, at the time, fulfilled accounting standards and anticipated redundancy. It is unclear to RFDSW what circumstances could have led to the stated regeneration of positive financial returns from these assets 'particularly when much of the equipment and investments made in this industry can rapidly become obsolete due to technological innovation'. RFDSW further noted that the impact of this is a much higher depreciation cost and a higher rate of return which is built into the pricing model inflating the price increases beyond the consumer price index (CPI).

The RVAC and VRAC submitted that the revaluing and then charging out new depreciation, as well as ongoing maintenance, is 'double dipping' and in its opinion should not be allowed. It was further noted that Airservices' budget provides for those expenses and accordingly they have already been factored into costing.

SMABC rejected Airservices' revaluation of assets that had previously been written off because they were loss making at the time and stated that Airservices should not then be able to recover the resulting increased book costs from the aviation industry. SMABC claimed that the potential for writing off assets in the future and then subsequently revaluing them upwards at a later date would not contribute to long-term stability in Airservices' pricing.

DPIWA stated that the current tower at Jandakot airport was built in 1963 and contains only basic infrastructure for TN and noted that Airservices had not indicated what value the tower asset has been assigned in determining asset costs at Jandakot airport. However, DPIWA suggests that it should be minimal.

Great Barrier Reef airport submitted that the data in Airservices' model relating to the assets employed at Hamilton Island is incorrect. Great Barrier Reef airport cites the increase in the asset written down value from $20 000 in year one to $80 000 in year five, however, notes that the only refurbishment project mentioned for Great Barrier Reef airport has a value of $40 000, leaving at least $20 000 in project costs unaccounted for. It is further stated that if the investments are an allocation of national costs, there has been no basis of the allocation provided.

7.1.8ACCC views

In its past decisions, the ACCC has expressed the importance of a transparent, timely and independent review of Airservices' assets. The ACCC therefore welcomes Airservices' approach to establish, in consultation with the industry working group, the terms of reference for an independent consultant to review the ODRC value of its asset base. The ACCC acknowledges Airservices' endeavours to gain support from its

customers involved in the ISC on its approach to valuing the asset base and allowing them the opportunity to review the detail of the Hyman report.

However, as with other parts of Airservices' proposal, the ACCC notes that there is a dichotomy of views in relation to the transparency of the revaluation process and a lesser degree of consultation afforded to regional and GA stakeholders.

The ACCC's Draft Statement of Principles for the Regulation of Transmission Revenues states that the ACCC's preferred approach to asset valuation is to 'lock-in' the value of the asset base. However, if the ACCC decides to re-value the asset base, it would apply a DORC approach to asset valuation.[20]

Given the previous uncertainty surrounding the valuation of Airservices' asset base, the ACCC considers it appropriate that Airservices undertook to engage an independent consultant to conduct a valuation. The ACCC recognises that the value of Airservices' asset base as stated in the Hyman's report has been supported by those customers involved in the ISC and by those stakeholders who felt they had been adequately consulted on this issue. The ACCC notes Airservices' agreement to the approach suggested by participants in the ISC that no further asset valuations will be undertaken that would adjust prices within the pricing period or at the beginning of the next cycle. Further to this, Airservices has agreed in principle to track the value of its asset base accounting for its actual capital spend, depreciation and asset disposals.[21]

The ACCC endorses this approach and considers that this value of Airservices' asset base can now be used as a reference point for future notifications, taking into account new, efficient investment.

The ACCC notes that there may be times when it is appropriate to revalue assets that have been previously written down with a nominal value. An example of this is where there was a high potential for stranding of an asset and the threat of by-pass is now diminished.[22] However, the ACCC has not been provided with full details surrounding Airservices' previous asset write-downs, nor has the ACCC independently verified the methodology or outcomes of the Hyman report.

Given the nature of the regulatory regime governing Airservices, in which the ACCC has had only irregular involvement in assessing Airservices' revenue at times of notifications of price increases, the ACCC considers that it would be a highly complex task to make an accurate assessment of whether the writing down and subsequent revaluation of assets involves any 'over-recovery' of revenue. Given the relatively small effect that this item has on Airservices' overall revenue, the ACCC does not consider this is warranted. In addition, given the acceptance by members of the ISC of the asset valuation made by Hymans, the ACCC is prepared to accept the value of the asset base as at 1 July 2004 put forward by Airservices.

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[20] ACCC, 'Review of the draft statement of principles for the regulation of transmission revenues—2003', p. 14.

[21] Airservices Australia, 'Long term pricing consultation meeting—minutes' 30 January 2004.

[22] ACCC, 'Statement of principles for the regulation of transmission revenues—1999, p. 51.

The ACCC expects that Airservices' move to longer-term pricing arrangements marks a shift in the nature of the regulatory regime. The ACCC expects that, once a longer-term pricing arrangement is in place, Airservices' interactions with the ACCC will be on a regular basis, i.e. every five years Airservices would submit a new pricing arrangement and provide the ACCC with necessary information covering the past five years as well as projections covering the period of the new pricing period.

Capital expenditure

7.1.9 Introduction

In its 2003 decision, the ACCC noted that Airservices had made attempts to improve the level of transparency around its capex budget through consultation with users. This followed advice provided by Airservices identifying its intent to start an ongoing regular consultation process to link capex programs with customer expectations over pricing outcomes.[23]

7.1.10 Airservices' position

Airservices has proposed a $542 million capex program over the period 2004–05 to 2008–09. In comparison, Airservices' capex program over the previous five years (1999–90 to 2003–04) involved an expenditure of $214 million.

Airservices states that its capex program is based on investment requirements driven by:

- safety—to meet mandatory requirements at minimum cost or to take reasonable steps to improve the safety of air navigation in Australia
- renewal—to maintain the asset base necessary to meet current service requirements
- efficiency—delivering service at a minimum cost
- capacity—to increase Airservices' capacity to meet expected increases in traffic levels (other than by increasing staff numbers)
- improved services to industry.

Airservices also states that the environment which Air Navigation Service providers operate in is dynamic and necessarily requires a flexible approach to capital budgeting.

As part of the development of the proposed capex program, Airservices has stated that it will work co-operatively with its customers, to make joint decisions on significant capital investment and to manage variations in the capital program as uncertainties are resolved.

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[23] The consultative process may be seen as an attempt to establish aspects of a 'quasi market', in which various customers' needs and willingness to pay for those needs are combined with the service supply actions and costs of Airservices.

Airservices submits that the pricing impact of cumulative variations in capex during the term of the five-year pricing arrangement should be carried forward into subsequent pricing agreements. However, Airservices states that where capex is anticipated to differ from plan by 50 per cent or more within a single year, or by 25 per cent cumulatively, a price variation may be required (up or down) to recognise the impact of large-scale changes in the overall program scope and schedule.

Airservices has developed its capex program in response to the *Australian Air Traffic Management Strategic Plan: 2003-2015* issued by the ASTRA, of which Airservices is a member. Initiatives for the next five to seven years were proposed and following internal review and consultation with customer groups a $542 million capex program was developed.

Airservices notes that while its customers have generally endorsed the proposed capex program, the ISC has 'expressed reservations about the requirement for surface movement guidance systems totalling $14.6m proposed at Brisbane and Melbourne airports'. Airservices states that its regional and GA consultation process did not reveal any other specific concerns with the investment programs (besides affordability concerns), but encouraged Airservices to adopt a re-allocation of some investments at particular locations.

Airservices submits that specific project approvals will be undertaken depending on the level of the proposed investment. Airservices states that:

- projects with a total capex in excess of $1 million, or which have a major impact on Airservices' operations, require a detailed business case (this consists of a series of pre-specified elements, including a discounted cash flow investment analysis)
- projects between $100 000 to $1 million require a rigorous business case and appropriate industry consultation
- projects with a total capex of less than $100 000 and with a relatively small impact on Airservices' operations will be approved and managed at the local management level.

7.1.11 Views of interested parties

The ACCC sought comments in its issues paper from interested parties on the efficiency of Airservices' proposed capex program, including:

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

There were significant differences in the responses of parties to these issues.

ADG, BARA, Qantas and Virgin Blue were generally supportive of the approach adopted by Airservices in relation to the capex program.

BARA, Qantas and Virgin Blue supported the capital projects included in the proposal, with the exception of surface movement guidance systems for Brisbane and Melbourne airports. These parties agreed with the cost estimates underlying the capital projects and were strongly supportive of the approach taken to determining the capex program over the period covered by the pricing proposal.

BARA argued that the technology for air traffic management is evolving rapidly and that Airservices should be given a reasonable amount of flexibility in specifying its future capex program. BARA also argued that, while the proposed capex program represents a 'best guess', it is a 'best guess' that has been fully explored with the industry.

BARA, however, did not support the proposal for ground movement radars at Brisbane and Melbourne airports and stated that it had been advised that the same level of safety could be achieved by using more efficient methods such as ADSB technology.

Qantas considered that the overall program achieves a reasonable spread of benefits across all users. In relation to the capex proposed at Brisbane and Melbourne airports, Qantas stated that, while it is not convinced that more efficient alternatives have been explored, it recognises that Airservices has involved Qantas in the consultation process in examining the requirements for the surface movement guidance system.

Qantas stated that it recognised that the proposed capex program is indicative only and will need to be updated over time as technological and regulatory issues are progressed.

Virgin Blue argued that it supported Airservices' moves to improve safety, but suggested that the same level of safety could be achieved at Brisbane and Melbourne airports by using more efficient methods that are currently available, such as ADSB technology. In relation to the remaining proposed capex items, Virgin Blue made the following comments:

- some of the projects will result in reductions in operating costs and improvements in safety
- Virgin Blue was a member of a working group which was provided with the opportunity to examine Airservices' proposed capex and was satisfied that the cost estimates were reasonable
- Virgin Blue is very supportive of the approach used in determining the capex program over the period covered by the pricing proposal.

Virgin Blue also emphasised that safety issues were a principal driver in accepting Airservices' capex program, with many of the items such as new fire trucks and refits to control towers being primarily safety related.

ADG commented that the level of proposed investment at Darwin airport appeared reasonable. In respect of Alice Springs airport, it suggested that a provision could be included for the replacement of both the fire station and the tower.

Submissions received from Great Barrier Reef airport and RFDSW identified support or qualified support for the proposed capex program.

Great Barrier Reef airport commented that Airservices has very little capex planned for Great Barrier Reef airport. However, it identified one project, to refurbish the antennae towers, which it considers 'probably appropriate', considering the age of the towers and the environment they operate in.

RFDSW stated that the proposed level of future investment in control tower facilities at Jandakot and Perth airports appeared to be reasonable. RFDSW also stated that it expected to see a significant reduction in the cost of providing en route air traffic control, which is not currently reflected in the pricing projections. RFDSW also suggested that some of the capital projects planned appeared to be outdated in terms of existing technology.

Gold Coast airport stated that, while the cost of the replacement of the Terminal Area Radar (TAR) is reasonable, there is doubt as to whether or not it is operationally required. According to Gold Coast airport, there needs to be an investigation into the operational necessity of a replacement and if that finds in the affirmative, then new technologies that are direct substitutes for conventional radar also need to be considered. Gold Coast airport further stated that, until such time as an investigation has taken place, the cost of the TAR replacement at Gold Coast airport should be removed from the capex program.

Submissions received from Cairns PA, GAM, Maroochy SC and SMABC raised issues about Airservices' approach to recovering costs associated with the capex program.

According to Cairns PA, the main area of concern about the capital program relates to the method of apportionment of costs (based on landed tones) for national capital programs such as the national tower upgrade program across airports. Cairns PA questioned whether this is an appropriate mechanism for apportioning capital costs, as such an apportionment does not take into account the condition of existing assets at airports.

Cairns PA requested information from Airservices about how capital costs have been apportioned for other programs, in particular, to assess whether specific capital programs have a greater application in the regional management of airspace and the larger towers in Australia than at smaller towers such at Cairns. Cairns PA also requested that Airservices provide full transparency on the break-up of capital projects between relevant airports and the application of the mechanism by which the capital is apportioned across airports.

GAM stated that it had no doubt that the expected cost of the capex program was adequate and that the expenditure was required. It, however, raised concerns that, based on its observations, Airservices was expecting to recover the cost of the capex program over a five-year period.

GAM argued that most capex, especially of the magnitude proposed by Airservices, would involve a recovery period of at least 10 years, if not 15 years. It also questioned what assurances there are that, once capex has been recovered, charges would be reduced.

GAM recommended a 10-year recovery period for capex, which it considered could result in a saving of over $25 million a year. A change in the way Airservices recovers its capex could also, according to GAM, result in Airservices recovering enough revenue 'to revert back to the 2002 prices as required by the ACCC, and still recover enough revenue to be in the black'.

Maroochy SC commented that while capital costs seem reasonable, consideration should be given towards network pricing for capex rather than location-specific pricing. It argued that, in the past, the cost of construction of fire stations, radar etc has been funded nationally. According to Maroochy SC, location-specific pricing places an unfair burden on airports that are just commencing ARFF services, as they have the full capital cost being charged to that airport.

SMABC rejected the proposed expenditure of $4 million on a new control tower at Bankstown. SMABC argued that Airservices or Bankstown airport should pay for the tower and neither should attempt to recover their costs in any manner from the aviation industry which sees no need for a new tower, or even the existing tower.

SMABC also expressed concern, in the absence of sufficient detail, over how capex is allocated in the 'basin' formula. It stated that it may be that capex at Sydney airport results in an increase in charges at Bankstown or Camden airports.

Submissions from RAAA and RFDS raised issues in relation to a ministerial direction recently issued to Airservices requiring the establishment of radar services at regional airports across Australia.

RAAA stated that 'given that this program appears to have been turned on its head by the Minister's direction of 31 August 2004—an apparent addition of several tens of millions to a proposed $542 million program—there is little basis on which one can comment'. The RAAA also identified concerns about the proposed upgrading of the tower at Albury, which it considered should be closed.

RFDS stated that it had no comment on the capital issues as presented. However, it made a number of comments in relation to the ministerial direction and stated that Alice Springs will certainly be one of the 10 airfields if this 'radar nonsense' proceeds.

Submissions from Linfox, Mackay PA and Rockhampton CC raised concerns regarding the adequacy of location-specific information in relation to the proposed capex program.

Linfox identified that, other than at Appendix 3 of Airservices' draft price notification, there is no specific breakdown of the proposed capex program. It noted that there has been no capex by Airservices at Essendon airport for many years and expected that most of the proposed capex will occur at major capital city airports.

Linfox argued that Airservices' proposed capex program does not indicate why Airservices' asset costs at Essendon airport are currently $780 000 per annum.

Mackay PA noted that it was not apparent what the capex for the ARFF services is over the five years as this was not included in the location-specific summary.

Rockhampton CC stated that it had been difficult to discover the reasoning for the proposed level of capex at Rockhampton airport. RCC argued that it was not possible based on financial information provided to it by Airservices to determine what Airservices is intending to spend on ARFF services at Rockhampton airport.

Submissions from RVAC and VRAC stated that the proposed capex program is for the benefit of the major airlines. The submissions also stated that as nothing in the way of capex is proposed at Moorabbin airport, the proposed capex should not lead to any increases in prices at Moorabbin.

Gold Coast airport considered that Airservices needed to provide a more detailed explanation of the necessity for the proposed replacement of the TAR at Gold Coast airport.

7.1.12 ACCC views

Airservices is proposing a large capex program with expenditure of $542 million forecast over the five-year period to June 2009. In contrast, Airservices' capex over the previous five-year period (from 1999–2000 to 2003–04) totalled around $214 million.

Given the size and significance of Airservices' proposed capex program, it is important to ensure both that capital projects included are appropriate and that there is an efficient allocation of resources to the capex program.

The ACCC has identified three major issues associated with the efficiency of Airservices' proposed capex program. These relate to the appropriateness of the capital projects included within the proposal, the level of the estimated costs of the capex proposed and the approach taken to determining the capex program over the period covered by the pricing proposal.

(a) The appropriateness of capital projects included within the proposal

Airservices has identified the aviation industry group ASTRA as having a key role in the development of the capex program. Airservices suggests that ASTRA has a broad membership which includes representatives from airlines, relevant Australian Government agencies as well as representatives from other user groups including organisations representing aircraft owners and pilots.

The ACCC notes Airservices' comments that it has developed its capex program based on priorities identified in ASTRA's Australian Air Traffic Management Strategic Plan. Airservices also indicates that it has undertaken additional consultations with customer groups to consider the reasonableness of proposed capex projects including the proposed technical solutions implicit in them.

Airservices has documented its approval process for considering capex proposals, with all capex proposals over $1 million requiring business case studies to be prepared. Airservices has also provided the ACCC with copies of business case studies that have been prepared in relation to major capex projects. The ACCC notes that capex projects have different approval requirements depending upon the size of the proposed capex project, with all projects exceeding $5 million requiring Board approval.

The ACCC considers that it is appropriate that the capex program has been developed by Airservices in consultation with ASTRA. It would, however, also encourage Airservices to develop a closer dialogue with airport operators about what capex projects are being proposed.

Overall, the ACCC considers that there is a general level of agreement within the industry regarding the appropriateness of projects to be funded as part of the capex program. The ACCC also notes that Airservices intends to provide further information to it (prior to lodgement of its formal price notification) in relation to ground based radars at Brisbane and Melbourne airports, following further consultation with the Brisbane and Melbourne safety committees.

The ACCC considers that the approval processes that Airservices has established to approve capex projects appear reasonable and recognises that larger projects that can have a major impact on Airservices' operations should be assessed in greater detail than minor capex proposals.

The ACCC also notes that there may be a number of alternative technical solutions to air traffic management issues and therefore Airservices' decision making in relation to technical solutions can have a major impact on the efficiency and effectiveness of the capex program. The ACCC therefore encourages Airservices, in the interests of transparency and analytical rigour, to clearly document the basis of its consideration of alternative technical solutions in its communications with stakeholders and in its business case studies.

Airservices also states that its capital program is based on a number of drivers, with safety listed as the first such driver. This is also reflected in a number of the business cases provided to the ACCC by Airservices, in which safety concerns are given as a major justification for undertaking projects.

The ACCC would therefore also encourage Airservices to provide greater transparency about its approach to addressing safety issues and in particular to quantify the safety-related project outcomes of alternatives both in its business case studies and in its communications with stakeholders.

(b) The estimated costs of the proposed capex

The ACCC notes that most submissions, including those from Airservices' major customers, considered that the estimated costs for the capex program were acceptable.

The ACCC also notes the concerns expressed in the submission from GAM that, based on its observations, Airservices was expecting to recover the cost of the capex program over a five-year period. The ACCC has, however, been provided with

supporting financial information from Airservices which indicates recovery of capex costs through depreciation charges is based on the estimated economic life of the specific asset involved, which is often in excess of five years. The more general issue of cost allocation of asset costs is discussed in the structure of pricing chapter.

The ACCC also notes that a number of the proposed capex projects are dependent upon the adoption of the Global Navigation Satellite System (GNSS) over which there is still some uncertainty as to when it will be implemented. As any delays in the implementation of the GNSS could have a significant impact on the capex program, the ACCC would encourage Airservices to undertake a sensitivity analysis which details the likely impacts on the capex program if the uptake of GNSS is delayed.

Based on the views expressed by Airservices' customers on its estimated costs of the proposed capex program, the ACCC is prepared to accept these estimates for the purposes of the pricing proposal.

(c) Airservices' approach to determining the capex program over the period covered by the pricing proposal

Airservices' approach contained in its draft price notification to handling the monitoring/review of the capex program is to consult with its customers and make adjustments at the end of the pricing cycle or earlier if a significant variation in actual capex from forecast occurs during the life of the plan. The ACCC sought more precise details on both the processes for consultation (including decision-making processes) described in the draft price notification and the proposed mechanism for making adjustments at the end of the five-year period.

Airservices indicated to the ACCC that details of these arrangements are still to be finalised and that it intends to embody the principles in both its strategic partnering charters and in a separate agreement.

The ACCC also requested further details on any process for monitoring and documenting deviations from the proposed capex program. In response, Airservices stated that the proposed capex program will set the baseline against which it will be able to monitor and identify deviations for presentation at the six-monthly meetings of the ISC, using its normal financial reporting processes.

The ACCC encourages Airservices to more precisely specify both the processes for consultation in the event that changes are likely to its proposed capex program and the decision making process that would be followed to change the program, as part of its price notification.

(d) Conclusion

The ACCC recognises that Airservices' capex program has been developed in consultation with industry and is also supported by its major customers. It also considers that Airservices has in place reasonable administrative processes to internally assess capex projects.

The ACCC, however, encourages Airservices to increase the transparency and analytical rigour of its decision making in relation to issues associated with its choice

of technical solutions to air traffic management issues and its assessment of safety issues. This should include the provision of adequate information to stakeholders who suggest alternative solutions or who question aspects of Airservices' capital program.

In addition, the ACCC would encourage Airservices to undertake a sensitivity analysis which details the likely impacts on the capex program if the uptake of GNSS is delayed.

The ACCC also considers it is important for Airservices to detail the consultative and decision-making processes relating to its capex program it proposes to employ throughout the long-term pricing arrangement in its formal price notification.

Rate of return

7.1.13 Introduction

As explained earlier in this document, the relative size of the return on capital component of Airservices' allowable revenue is relatively small and thus forms only a minor part of the ACCC's assessment of Airservices' pricing proposal.

The return on capital is a component of the building block model which ensures that both debt and equity holders receive a rate of return that reflects the opportunity cost of capital. The WACC is the measure most commonly used by Australian regulators for determining a reasonable return on a regulated asset base.[24] The WACC is the weighted average of the costs of a firm's debt and equity financing sources and is applied to the regulated asset base to determine the return on capital for the period. [25]

The two components of the WACC are the cost of debt and the cost of equity. The cost of debt is defined as the debt margin added to the risk free rate, and varies depending on the firm's gearing, credit rating and the term of the debt. [26]

The cost of equity is the expected return required to compensate investors for bearing the risk associated with investing in a firm's equity. The ACCC's preferred approach to determine the cost of equity is to apply the capital asset pricing model (CAPM). The CAPM yields the required, average or expected return on a stock given the return on the market portfolio, the market's own volatility and the systematic risk of holding equity in the particular company. The cost of equity is a forward looking concept that determines the return expected by investors on their investment.

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[24] The appropriate determination of the regulated asset base to which the WACC is to be applied is discussed in Part 7.3 of this document.

[25] For a detailed discussion on the individual WACC components and the ACCC's views on these and related WACC issues please refer to the ACCC's discussion paper entitled '2003—Review of the draft statements of principles for the regulation of transmission revenues'. This document can be obtained from the ACCC's web site at www.accc.gov.au

[26] Draft decision, NSW and ACT transmission networks revenue caps—Transgrid 2004–05 to 2008–09, 28 April 2004, p. 80.

7.1.14 Airservices' position

At the initial industry consultation meeting in August 2003 it was agreed that the industry working group would jointly seek an independent review of Airservices' WACC by a mutually accepted consultant. The terms of reference for this review were established by the industry working group.

Subsequently, PwC was engaged by Airservices to determine its appropriate WACC. As outlined in Table 7.2, below, based on the prevailing five-year bond rate, PwC recommended 9.75 per cent as the nominal vanilla WACC as the simple midpoint of the range established by an assessment of the underlying parameters.[27] The details of this recommendation are set out in Table 7.2.

Table 7.2 PwC's Recommended parameters and WACC

Measure	**PwC recommendation**
Risk free rate	5.83%
Asset beta	0.55-0.65
Equity beta	1.0-1.3
Debt beta	0
Market risk premium	6%
Debt margin	0.6%-0.8%
Cost of debt	6.5%-6.7%
Gearing (D/V)	40%-50%
Dividend imputation	50%
Cost of equity (post-tax nom)	11.8%- 13.6%
Nominal Vanilla WACC	**9.4%-10.1%**
Post tax nominal WACC*	6.9%-8.2%

Airservices has adopted PwC's recommended WACC of 9.75 per cent as the normal target return. However, in developing the pricing strategy, the ISC was concerned that the cost of transitioning under the new price arrangement should not be solely borne by the airlines and considered that Airservices should also contribute to this outcome. Consequently, Airservices agreed to target a lower WACC in 2004–05 and to

[27] Airservices Australia ' Draft price notification—August 2004', p. 13.

progressively increase this to 9.75 per cent by 2008–09.[28] Table 7.3 outlines Airservices' proposed target WACC profile over the five-year period.

Table 7.3 Airservices' target WACC profile - 2004–05 to 2008–09

	2004–05	2005–06	2006–07	2007–08	2008–09
Increasing WACC target	6.00%	7.25%	8.50%	9.25%	9.75%

Airservices states that the reduced WACC target will act as a formal incentive to seek additional productivity efficiencies to achieve a normal return during this period.

7.1.15 Views of interested parties

The ACCC sought comment from interested parties 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, and the extent to which the proposal would act as an incentive on Airservices to achieve increases in productivity.

There was a general acceptance of Airservices' proposed rate of return amongst those parties who had been a part of the ISC. However, this acceptance was given notwithstanding objection to certain parameters. A number of other stakeholders were of the view that the proposed rate of return is not an appropriate incentive to ensure Airservices achieves productivity gains, and considered that the proposed rate of 9.75 per cent was excessive.

BARA, Cathay Pacific, Emirates IATA, Qantas and Virgin Blue support Airservices' proposed phase in of its WACC and acknowledged that this initiative was in response to concerns raised by the airlines that they were continuing to subsidise regional and GA locations.

Cathay Pacific and Emirates fully support the views expressed by IATA and agree with Airservices' outcome relating to its target return on capital. However, IATA noted that while it appreciated Airservices' decision to seek a progressively increasing WACC to reduce the negative impact of higher charges on mainstream airlines, IATA member airlines would still be asked to pay higher charges than would be necessary if either the government met its full obligation or if location-specific charges on a fully allocated cost base were established.

BARA, Virgin Blue and Qantas noted that Airservices' accepted phasing in of its rate of return to its full WACC was in response to the concerns of the major airlines that they were continuing to subsidise regional and GA airports. However, they submitted that the reduction in Airservices' revenue associated with the reduced WACC is

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[28] Airservices Australia 'Draft price notification—August 2004' p. 14.

substantially lower than the losses that the major airlines incur from cross subsidising other users.

Qantas and BARA stated that notwithstanding this, the acceptance of a lower rate of return by Airservices establishes an important precedent in recognising the burden of cross subsidies on major RPT operators.

ADG, BA, Mackay PA, Maroochy SC and Singapore Airlines accepted Airservices' proposed WACC.

ADG noted that industry has had the opportunity to review the rate of return issue through the ISC and working group, and stated that whatever rate is determined for Airservices, it should in no way influence the rates applicable for airports.

BA stated that it was 'pleased' to see that an agreed solution was found in defining the level of WACC, and noted that the use of a third party in determining the level provided a 'great level' of assurance that Airservices would be 'incentivised' to behave efficiently.

The Mackay PA noted in its submission that as long as cost savings through efficiency gains or sub-contracting of services takes place then it accepts that an industry comparable rate of return should be realised on capital.

The Maroochy SC supported Airservices' use of a WACC to determine an appropriate rate of return. The council noted that the rates are comparable to the latest calculations for the Sunshine Coast airport.

Singapore Airlines accepted Airservices' proposal to phase in its rate of return over the term of the proposed price arrangement and acknowledged that it is difficult for most regional and GA operators to bear the price hike originally proposed, stating that a more moderated progression toward the location-specific pricing model is appropriate.

Adelaide airport submitted that the rate of return should be no more than that expected by any competent business operation, based on the optimised depreciated cost of assets and GAM was of the view that this (the rate of return) is an 'essential' and well regarded requirement.

BARA, Gold Coast airport, Qantas and Virgin Blue noted their objection to certain parameters embodied in Airservices' proposed WACC. The main parameter of contention was the asset beta, and concerns were also raised in relation to Airservices' equity beta, debt margin and gearing ratio.

Qantas, Virgin Blue and BARA were of the view that Airservices' proposed asset beta was too high. Qantas reiterated its concerns over the asset betas afforded by the ACCC to regulated industries, citing that empirical evidence indicates that the asset betas of listed companies on the Australian Stock Exchange are far lower than those adopted by the ACCC. BARA's view was that the asset beta included in Airservices' WACC is too high. However, it stated that, in the interests of meeting an agreement with Airservices, it was willing to accept the proposed WACC. Virgin Blue noted its

view that Airservices' debt margin and asset beta implicit in the WACC is generous (albeit marginally) towards Airservices, but is willing to accept the proposed WACC.

Gold Coast airport submitted that an equity beta of between 1.0 to 1.3 as recommended in the PwC report is high given the nature of Airservices' business and its customer base. It suggested a value of below 1.0 would be more appropriate. In relation to Airservices' gearing ratio, Gold Coast airport stated that with the cost of debt less than the cost of equity, the level of gearing for capital investment should be increased to a sustainable level, which would promote additional efficiencies for users through the reduction of the WACC and ultimately the charges levied.

Cairns PA, Jandakot Airport CC, RAAA and SMABC were of the view that Airservices' proposed WACC of 9.75 per cent was too high.

Cairns PA questioned the appropriateness of a 9.75 per cent return given that there is potential to review capex and also a potential to review volume of activity.

The Jandakot Airport CC submitted that a 9.75 per cent rate of return for a monopoly business is excessive and that Airservices' rate of return should not exceed the five year bond rate. The Jandakot Airport CC stated that this view is supported by the knowledge that 83 per cent of Airservices' revenue is derived from non-capital costs which is in contrast to most other regulated infrastructure entities. That is, it considered that Airservices is more of a cash-flow business than a capital intensive business.

SMBAC noted that that while it is difficult to accurately estimate the WACC for the GA sector, it is considered that its WACC would be lower than the 9.75 per cent put forward by Airservices.

The RAAA submitted that in determining an appropriate WACC, Airservices should be treated as a government monopoly service provider and not as a commercial operation subject to the full competitive force of an open market. The RAAA stated that from this perspective, there is no justification for such a high rate of return noting that anything above a reasonable rate of return on investment to permit cost efficient replacement of asset and sensible provision of services, which allows a dividend to be paid to government, is effectively double taxation. The RAAA also stated that the phasing in of such a high WACC does not alter this basic situation, as a guaranteed rate of return, albeit phased in, seems to the RAAA to remove any incentive for Airservices to make its operations more efficient.

Gold Coast airport, Great Barrier Reef airport, RVAC, SMABC and VRAC did not endorse the view that Airservices' proposed WACC would act as an incentive to achieve productivity increases.

Gold Coast airport considered that identified efficiencies should be reflected in the current calculations and should always be the responsibility of Airservices without the need for a formal incentive, further noting that any identified cost savings should be passed on to users immediately and not be the goal for the next five years.

Great Barrier Reef airport stated that the proposal put forward by Airservices for its proposed rate of return is unsupportable in today's competitive environment. Great

Barrier Reef airport noted that if a regulated firm is able to dictate a specific return on assets employed as a determinate of pricing, then there is no mechanism that can be put in place to ensure Airservices operates efficiently.

The RVAC and VRAC stated that they were 'highly sceptical' that Airservices' desire to achieve a 9.75 per cent return on assets is an adequate incentive to management to control costs. It noted that it does not know what penalty applied to management (including the board) if the rate of return is not achieved. It also noted that any profit made by Airservices is an unnecessary charge on current users for the benefit of others, including the Australian Government.

SMABC stated that it could not see how a gradually increasing WACC will provide any incentive for Airservices to become more productive and considered that any increase in Airservices' WACC is more likely to lead to increased prices rather than improved efficiencies.

Qantas stated that the extent to which a reduction in the WACC will encourage further increases in productivity by Airservices is uncertain and that the development of an agreed price path will act as the main incentive for Airservices to efficiently manage its costs.

7.1.16 ACCC views

The ACCC considers that there are two main issues arising from the proposed WACC: the reasonableness of Airservices' determined 'normal' rate of return; and the appropriateness of Airservices' proposed phase-in of its WACC over the five-year period.

(a) The reasonableness of Airservices' 'normal' rate of return

In determining Airservices' return on capital in 2003, the ACCC encouraged Airservices to undertake further analytical work in consultation with its customers as part of the development of a forward-looking longer-term pricing framework. The ACCC therefore welcomes the approach taken by Airservices in commissioning an independent consultant to recommend a rate for its WACC.

A number of parties represented on the ISC noted their objection to the determination of certain parameters of the WACC, but were prepared to support a WACC of 9.75 per cent as proposed by PwC, in the context of the overall pricing proposal. The main parameter of contention was the appropriateness of an asset beta of between 0.55 and 0.65, which was considered by BARA, Qantas and Virgin Blue to be too high.

The asset beta is a measure of the risk associated with an asset's cash flows and controls for the risk arising from an organisation's capital structure. In 2002 the ACCC considered that the appropriate range for Airservices' asset beta was between 0.55 and 0.75, based on a comparison of asset betas used in previous aeronautical pricing decisions. It was subsequently decided that an asset beta of 0.7 was likely to reflect the systematic risk of Airservices' returns. In 2003 the ACCC considered it would be more appropriate for the asset beta to be set at the lower end of the range 0.55 to 0.75, based on Airservices' short-term approach to pricing.

As discussed in the long-term pricing plan section of this document, the inclusion of trigger mechanisms in Airservices' proposal makes it unclear what the resultant sharing of risks will be in practice. It is therefore unclear to the ACCC whether Airservices is taking on any additional level of risk than it has in the past. It therefore seems appropriate to apply an asset beta of 0.55, which is at the lower end of the range previously determined by the ACCC. Given the relationship between the asset and equity betas and the nature of Airservices' operations, the ACCC is of the view that the resulting equity beta of 1.0 is appropriate.

The ACCC notes the view of Gold Coast airport in relation to Airservices' proposed gearing ratio, that it should be increased to a 'sustainable level'. The ACCC, in its 2002 and 2003 decisions, applied a gearing ratio of 40 per cent. Although this differs from the typical capital structure assumed by regulators of 60 per cent, the ACCC accepted in its 2002 decision that the magnitude of the effect of employing a 40:60 capital structure was relatively small and, in the case of Airservices, it was prepared to move away from the 60:40 benchmark. The ACCC maintains this position and therefore considers the adoption of a gearing ratio of 40-50:50-60 to be acceptable.

Virgin Blue submitted that the debt margin proposed by Airservices was generous, albeit marginally. In its 2002 and 2003 Airservices decisions, the ACCC accepted Airservices' use of an AAA credit rating, which reflected its actual credit rating, and applied a debt margin of 0.50 per cent and 0.42 per cent respectively.

In this proposal, Airservices has accounted for debt raising costs in the WACC debt margin spread, rather than in its operating expenditure. The ACCC considers that since these costs are not recurring, they would be more appropriately recovered as operating costs in the relevant year. Airservices has provided the ACCC with estimates of its debt raising costs of $200 000 for the 2004–05 financial year. Excluding these costs, the ACCC considers that a debt margin of 0.55 is more appropriate, given the market conditions at the time of Airservices submitting its draft notification, and therefore is of the view that Airservices' proposed range of the debt margin of 0.60 to 0.80 is high.

In assessing the risk-free rate, the ACCC has calculated a 10-day moving average of the nominal risk-free rate just prior to releasing this preliminary view. This results in a rate of 5.41 per cent.

As a result of applying an asset beta of 0.55, a debt margin of 0.55 and a risk-free rate of 5.41 per cent, the ACCC considers that Airservices' WACC should be 8.95 per cent.[29]

(b) The appropriateness of 'phasing in' Airservices' WACC

Airservices has proposed to target a lower WACC in 2004–05 of 6.0 per cent and to progressively increase this to 9.75 per cent by 2008–09. Airservices' proposal to phase in its WACC over the pricing period was in response to concerns raised by the

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[29] The vanilla WACC is derived by the following formula: $WACC = r_e (E/V) + r_d (D/V)$, where r_e = required rate of return on equity or cost of equity; r_d = cost of debt; E = market value of equity; D = market value of debt; V = market value of equity + debt.

ISC that the costs associated with transitioning to full cost recovery should not be solely borne by the airlines, which resulted in a compromised outcome in which Airservices contributed to this cost through targeting a lower WACC. Airservices stated in its submission that, 'this reduced target would also act as a formal incentive to seek additional productivity efficiencies to achieve a normal return during this period'.[30]

The ACCC considers it inappropriate to alter the WACC unless its underlying parameters are changing. At present, there does not appear to be any legitimate reason to substantiate any systematic change over the five-year period of Airservices' underlying WACC parameters.

The ACCC does not support Airservices' proposal to include varying rates for its WACC over the five-year period. The ACCC's approach to determining the WACC to allow a regulated entity is based on the opportunity cost of capital. It does not vary according to factors such as phasing in price increases or as an efficiency incentive. The ACCC is of the view that if Airservices is to bear some of the costs associated with the adoption of lower prices to some users, then this should be allowed for through adjustments in its cash flows or the use of a CPI–X price path, rather than in choosing to adopt a lower WACC.

Airservices' proposal to phase in its WACC will have the ultimate effect of reducing its revenue by approximately $40.5 million over the pricing period. The ACCC is of the view that this reduction in revenue may provide Airservices with an incentive to increase its productivity and reduce costs to achieve a higher return over this period. However, the ACCC considers that it would be preferable to account for such efficiency gains through an explicit incentive mechanism, such as a CPI–X price cap.

(c) Summary

The ACCC is of the view that an appropriate value for Airservices' WACC is 8.95 per cent. This is based on lower values for the risk-free rate, the asset and equity betas and the debt margin.

The ACCC has applied a risk-free rate of 5.41 per cent, on the basis of current market conditions, applying a 10-day moving average of the nominal risk-free rate just before releasing this preliminary view. The ACCC considers that appropriate values for the asset beta and equity beta are 0.55 and 1.0 respectively. These are at the low end of the ranges recommended by PwC, reflecting the ACCC's judgement of the level of risk Airservices faces. The ACCC has also applied a lower debt margin (0.55) which excludes any impact of debt raising costs which it considers is more appropriately included in opex.

The ACCC does not support Airservices' proposal to apply different WACCs over the pricing period and considers it inappropriate to alter the WACC unless its underlying parameters are changing.

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[30] Airservices Australia 'Draft price notification August 2004', p. 14.

Table 7.4 compares Airservices' allowable revenue using a WACC of 8.95 per cent with Airservices' proposed allowable revenue using changing values for the WACC over the period 2004–05 to 2008–09.

Table 7.4 Alternative WACCs and Allowable Revenue

	2004–05	2005–06	2006–07	2007–08	2008–09	Total
	$	$	$	$	$	$
Constant WACC 9.75%	603,250,186	630,496,192	649,229,070	672,763,768	691,742,009	3,247,481,226
Constant WACC 8.95%	599,485,959	626,338,122	644,699,584	667,986,061	686,784,059	3,225,293,783
Difference	3,764,227	4,158,071	4,529,487	4,777,707	4,957,950	22,187,442
Phase in of WACC	585,605,370	617,502,221	642,151,747	669,777,701	691,742,009	3,206,779,049
Difference between ACCC WACC and phase-in	13,880,588	8,835,900	2,547,836	(1,791,640)	(4,957,950)	18,514,734

Table 7.4 shows that by applying a rate of return of 8.95 per cent in each period, compared with a rate of return of 9.75 per cent, Airservices would recover approximately $22 million less over the five-year period.

The ACCC notes that Airservices proposes to accept a lower stream of revenue over the pricing period as a way of sharing the cost of transitioning to location-specific prices with the airlines. However, the ACCC considers Airservices' approach in seeking to achieve this result is inappropriate. The ACCC is of the view that any adjustment to lower allowable revenue should be made through Airservices' cash flows.

Airservices also submits that targeting a lower WACC will act as a formal incentive for it to seek additional productivity efficiencies to achieve a normal return during the pricing period. The ACCC considers that any efficiency mechanism should be incorporated in a separate and transparent efficiency incentive relating to its operating and maintenance costs.

However, given that Airservices' proposed total allowable revenue shown in Table 7.4 is less than the revenue the ACCC would accept with its revised WACC, the ACCC is not opposing the allowable revenue implicit in the pricing proposal.

Summary

The ACCC is satisfied that Airservices' proposed operating and capital expenditures are broadly efficient and that the value of its tax allowance and stated depreciation allowance are not unreasonable.

Given the nature of the regulatory regime governing Airservices, in which the ACCC has had only irregular involvement in assessing Airservices' revenue at times of notifications of price increases, it has been difficult for the ACCC to assess the reasonableness of Airservices' asset base valuation. Given the relatively small proportion of Airservices' revenue made up of return on capital, the ACCC is willing to accept the value of the asset base put forward by Airservices for the purposes of this pricing proposal. The ACCC considers that the value of Airservices' asset base can now be used as a reference point for future notifications, taking into account new and efficient investment.

In relation to Airservices' proposed 'normal' WACC of 9.75 per cent, the ACCC considers that a WACC of 8.95 per cent is more appropriate. This is based on values for the asset beta (0.55) and equity beta (1.0) which are at the low end of the range recommended by PwC, reflecting the ACCC's judgement of the level of risk Airservices faces. The ACCC has also applied a lower debt margin (0.55) which excludes any impact of debt raising costs, which it considers is more appropriately included in opex, and a risk-free rate of 5.41 per cent.

The ACCC does not support Airservices' approach of phasing in its WACC over the period of the pricing proposal. Changes to the WACC should only be made to reflect changes in its underlying parameters. The ACCC considers that, if it is desirable for Airservices to accept a lower revenue stream over the pricing period as a way of sharing the cost of transitioning to location-specific prices, this should be effected through an adjustment to Airservices' cash flows. In addition, while the resulting reduction in revenue by $40 million may provide Airservices with an incentive to increase productivity and reduce costs to achieve a higher return, the ACCC considers that it would be preferable to account for such efficiency gains through an explicit efficiency incentive.

However, given that the effect on revenue of Airservices' phasing in of its WACC is greater than the effect of the ACCC's view of the appropriate rate of WACC, the ACCC accepts the values for return on capital and therefore also the total revenue amounts proposed by Airservices.

8 Activity levels and forecasts

Introduction

Forecast aeronautical activity levels have a significant and direct influence on the prices that are proposed by Airservices. After the appropriate level of regulated revenue is determined, the final prices charged for Airservices' regulated services will be determined by activity levels.

In its decisions on Airservices' 2002 and 2003 pricing proposals, the ACCC generally accepted the activity forecasts provided by Airservices. However, the ACCC encouraged Airservices to provide substantiation for the levels of future activity assumed and, in line with the ACCC's recommendations concerning longer-term pricing structures, to support its forecasts by reference to a long-term forecast of activity levels by an independent party.

Airservices' position

The ISC recommended that Airservices engage the IATA's Forecasting and Consulting Unit to develop a forecast of activity for the next five years and agreed that Airservices was to abide by the unit's recommendations. The IATA forecast modelled the derived flight activity and the number of charging units from an initial forecast of passenger demand.

Table 8.1 outlines the IATA forecast activity growth rates for en route, TN and ARFF services at major, regional and GA airports

Table 8.1: Forecast activity growth rates

	2004–05	2005–06	2006–07	2007–08	2008–09
En route	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%
GA airports	1.0%	2.0%	2.0%	2.0%	1.8%
Weighted average	**4.7%**	**4.9%**	**4.1%**	**3.9%**	**4.7%**

Airservices has proposed chargeable unit forecasts for en route, TN and ARFF services at each location (major, regional or GA airports). Airservices noted that its consultation with airports and other regional customers suggested that the regional and GA airport forecasts are optimistic and significant price increases in Airservices' charges is likely to result in a contraction of demand. Airservices considered that determining the reaction of the market to its pricing proposal in isolation of other factors, such as fuel costs and airport charges, would be extremely difficult when determining future demand. Therefore Airservices decided to retain the IATA forecasts as an objective basis for pricing.

To mitigate the risks posed by volatility in activity, Airservices proposes to adopt a watching brief over activity forecasts and to apply similar principles to those accepted to manage significant variations in the capital program. Airservices proposes that if activity levels fall or rise by 10 per cent or more within a 60-day period and/or are forecast to trend 5 per cent above or below the forecast quantitative levels in a financial year, the parties will consider the most appropriate means of addressing the situation, such as agreement to change cost levels through a change in service levels, a re-scheduling of capex or seek a price variation.

8.1 Views of interested parties

The ACCC sought comment from interested parties on the reasonableness of Airservices' activity estimates.

In general, those stakeholders involved in the ISC and representatives from major airports agreed with the activity forecasts put forward by Airservices. A number of regional and GA operators disagreed with the activity growth rates put forward by Airservices, stating that activity figures were either over or under stated. Concerns were also raised that Airservices' forecasts did not take into consideration the impact that increased prices would have on demand.

Adelaide airport, ADG, BARA, Cathay Pacific, Emirates, GAM, IATA, Qantas and Virgin Blue stated their acceptance of Airservices' activity forecasts.

Adelaide airport stated that Airservices' activity volumes appear to be reasonable. However, it noted that the uncertainty surrounding future prices could adversely affect future traffic volumes to surrounding un-serviced airfields.

ADG submitted that Airservices, through the operation of the ATC, has a large database of historical activity on which to base its calculations, and has used a recognised organisation to determine an estimate for future activity levels.

DPIWA, Jandakot Airport CC, RAAA, RFDSW, RVAC, SFCJ, SFC, SMABC and VRAC submitted that Airservices' proposed price increases were likely to decrease demand.

DPIWA stated in its submission that it and the major airport operators at Jandakot airport and Jandakot airport consider the implementation of the proposed price at Jandakot airport would result in a significant decrease in total activity. DPIWA submitted that there is potential for Australia to lose all international airline flight training schools to overseas competitors if the proposed prices at GA airports are implemented which would, at Jandakot airport, have a significant impact on Airservices' assumptions for activity and cost recovery, as the international flying schools account for over 40 per cent of movements. The effect of this would have serious implications for Jandakot airport which may have to raise its prices for remaining operators, which would lead to a further decrease in activity. DPIWA also noted that Airservices' estimates for activity do not appear to be dependent on price.

While Jandakot Airport CC considered the 1–2 per cent forecasts low based on its performance in the last three years and the growth in major training facilities, it considered that reductions in movements were a likely result of the proposed price

increases. It stated that eliminating one of its major training establishments would reduce monthly movements by over 3000.

The RAAA believes that notwithstanding the change in the current proposals, the price increases are still more than sufficient to dampen demand at towered regional and GA airports.

RFDSW stated that Airservices' activity estimates for GA are relatively low when compared to growth rates for other airports. However, it considered that if the price increase proposed for Jandakot airport proceeds, the overall forecasted activity volumes have the potential to decline as the GA operators either move to alternative airports where the fees are similar to those currently charged or non-existent, scale down their activity or close their business due to unavailability.

The RVAC stated that activity levels at airports, and in particular at Moorabbin, are mainly dependent on costs and therefore considered that Airservices' proposed activity forecasts are only reasonable if cost increases mirror CPI increases. It considered that activity growth would be negative if costs escalated beyond that.

SFCJ stated that the activity forecasts for Jandakot in Airservices' initial proposal were 'laughable', and are only 'slightly more realistic' in the current proposal. SFCJ noted that in the past, price increases have had an adverse effect on activity levels at Jandakot. Therefore the proposed price increase could result in reduced activity at Jandakot which would force Airservices and Jandakot airport to further increase prices to recoup costs ending up in a 'tail chase' situation.

SFC stated that the extent of the proposed charges and the choice of 3 tonnes MTOW as the lower limit for application of charges for fire services seemed likely to have a severe effect on aerial work operations at regional and some secondary airports. It also noted that the forecasts appear to rely on figures produced before the proposed price increases were announced and make no allowance for any negative growth as a consequence of the proposed increases.

SMBAC stated that the activity trend for almost all GA airports shows a sharp and continuing decline in movements, and if this trend continues there is concern that Airservices will further increase its prices to maintain its revenue which will lead to a further decline in activity and the possibility of even higher prices.

The VRAC referred to survey results issued by Bureau of Transport and Regional Services' Aviation Statistics and Analysis (BTRE AVSTATS) which supported its view that the GA industry in Australia was 'on its knees' and in decline, stating that it could not sustain the cost imposts which Airservices is proposing.

Archerfield airport, Great Barrier Reef airport, Linfox, RAAA and SMABC were of the view that Airservices has over-stated its forecasts of activity at a number of regional and GA airports.

Archerfield airport stated that, prior to the introduction of location-specific pricing by Airservices in 1998, Archerfield's average annual aircraft movements were in excess of 230 000 activities, however, since such time it has struggled to reach annual

movements of 150 000. Archerfield airport further stated that GA is at the poor end of the financial business scale and is very price sensitive.

Great Barrier Reef airport stated that Airservices' activity forecasts do not take into account the intention of the primary RPT operator, Jetstar Airways, to use larger aircraft at the same or of a lesser frequency into Hamilton Island, resulting in the actual tonnage staying close to what is currently being achieved and not the amount forecast by Airservices.

Linfox submitted that Airservices' proposed activity forecasts were 'strange' citing Airservices' own published statistics which show that over the past two calendar years, with the exception of Jandakot, activity at GA airports has declined on average by 14.71 per cent. Linfox stated that for Airservices to believe that this trend will immediately reverse and improve over the next five years while costs increase by 50 per cent is 'unfathomable' and shows a lack of understanding of the GA industry.

The RAAA noted that the growth predicted for regional airports and GA airports seemed intuitively wrong. Referencing BTRE AVSTATS the RAAA claimed that regional airline hours flown decreased by 6.6 per cent between 2001–02 and 2002–03 and in the same period all GA hours flown (excluding agriculture, which would not normally use towered airports) increased by only 1.3 per cent.

SMABC was of the view that Airservices' forecast activity levels are extremely optimistic especially given the propensity of Airservices, Bankstown Airport Limited and CASA to increase charges which the GA industry cannot absorb and which have already seen significant reductions in activity levels.

Cairns PA, Gold Coast airport, Mackay PA, Maroochy SC and Rockhampton CC were of the view that in their particular cases Airservices had under-estimated current activity, which would affect the accuracy of activity forecasts over the pricing period.

Cairns PA stated that the document that was provided showed 1.50 million landed tonnes for the financial year 2003–04. However, CPA's figure for 2003–04 is 1.55 million tonnes, an increase of 3.3 per cent. This would effectively vary the base year on future forecasts. CPA also noted its concern that the introduction of low cost carriers may have the potential to increase landed tonnes at a greater rate than proposed by Airservices, which also supports the view that variations in activity on a location-specific basis should be used to vary the price at that location.

The Mackay PA stated that Airservices had underestimated MTOW volume at Mackay airport as a consequence of using old throughput data, which resulted in Mackay airport being penalised with higher charges than it would otherwise encounter if the 'correct' activity forecasts were employed.

The Maroochy SC submitted that the Sunshine Coast airport is experiencing rapid growth in passenger numbers, well in excess of Airservices' forecasts for regional airports. As this growth is likely to continue for the next six to 24 months, the Maroochy SC suggests that a review should be carried out every six months so that activity forecasts can be adjusted and charges be based on actual aircraft activity.

Rockhampton CC submitted that from the information provided in the ATC and ARFF profit and loss statements, it is clear that Airservices' figures for tonnes landed at Rockhampton airport understate the airport management's figures. However, it noted that a portion of this can be explained through the hours of operation of ARFF and ATC. It also noted that Airservices' growth estimates are directly related to the per-tonne charge for its services and therefore, it is critical that these figures are as realistic as possible.

Gold Coast airport was of the view that Airservices' activity forecasts are optimistic in relation to some airports, however, in the case of the Gold Coast airport there has been a steady increase in activity greater than anticipated and which is considered to continue.

8.2 ACCC views

In its 2003 decision, the ACCC recommended the adoption of independent long-term activity forecasts in the development of a long-term pricing plan. The ACCC therefore welcomes Airservices' decision to engage IATA's Forecasting and Consulting Unit to undertake a forecast of activity over the next five years.

Airservices stated in its draft price notification that the IATA forecasts had been retained as an objective basis for pricing. The actual forecasts put forward appear to be based on the actual total tonnes landed recorded by Airservices in 2003–04, with the IATA growth rates applied to this figure.[31] This method and the resulting activity forecasts were endorsed by the ISC.

The ACCC notes the support for the activity forecasts from larger airlines and those with an interest in the larger airports. However, a number of regional and GA operators expressed their concerns that the forecasts are inaccurate and do not reflect the decline in growth experienced within GA over previous years. Submissions also considered that Airservices' forecasts do not take into account the likely demand response at regional and GA airports to Airservices' increased prices. In a smaller number of submissions, it was considered that Airservices has under-estimated current activity and/or growth rates at particular smaller ports.

The ACCC notes that Airservices' approach in determining activity forecasts does not appear to consider the individual circumstances of airports other than to make the distinction between major, regional and GA airports. In particular, Airservices has not attempted to take into account the likely demand response to an increase in prices at regional and GA airports. Any resulting over-statement of activity forecasts potentially places a greater risk on Airservices that it will not be able to recover its revenue, although this is subject to the activity trigger mechanism, which is discussed in the long-term pricing plan section of this document. The ACCC notes that to attempt to adjust for any likely negative impact on demand at regional and GA ports would result in higher proposed prices at those locations, which may be self-defeating.

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[31] The actual total tonnes landed recorded by Airservices in 2003–04 were 92.2 per cent of the forecast predicted by IATA. Subsequently, for each year of the period 2004–05 to 2008–09, Airservices has adjusted IATA's total tonnes landed forecast by this percentage.

The ACCC considers that Airservices' engagement of IATA to obtain an objective basis for activity forecasts and its general approach in deriving the growth rates of the major, regional and GA airports is appropriate. The ACCC also considers that in this case, the use of generalised growth rates for activity is a reasonable approach. However, as mentioned in the risk-sharing arrangements section of this document, it may be desirable for Airservices to enter into individual risk-sharing arrangements with particular airports regarding the levels of activity at that airport. This may address the concerns that a number of airport operators have with the activity forecasts used by Airservices for their airport.

9 Structure of Pricing

Introduction

The object of prices surveillance is to address markets where competitive pressures are not sufficient to achieve efficient prices and protect consumers. In assessing the structure of prices in Airservices' pricing proposal, the ACCC has considered the extent to which the pricing structure promotes the objectives of efficiency and equity. Efficient pricing requires that consumers be charged the marginal social cost of supply of a good or service. Prices that are not cost reflective will generally have an adverse impact on the efficiency of the resource allocation decisions by Airservices and its users.

Where a multi-product firm has no costs that are common or fixed across its services, allocative efficiency can be achieved by setting the price for each of the services equal to the marginal cost of supply. This is known as a 'first-best' approach to pricing. The term 'common costs' is used here to refer to those costs of shared inputs used in the production of several outputs, where the input proportions can be varied so that it is in principle possible to trace them to individual services.

'Fixed costs' are used here in the sense of stemming from indivisibilities in supply, so that the same level of equipment or facilities accommodates, at the same appropriate quality of service, a wide range of demand. In these circumstances, there are economies of scale or utilisation if the 'fixed cost' of the equipment is spread over higher demand; the associated unit costs fall. There are many examples of fixed costs in Airservices' en route navigation and terminal radar facilities.

However, where a firm, such as Airservices, has both fixed and common costs, marginal costs are generally below average total costs and hence strict adherence to marginal cost pricing will result in insufficient revenue to recover all costs.

In this case, Airservices may be limited to implementing a 'second-best' approach to pricing. This involves satisfying Airservices' need to achieve cost recovery while minimising the attendant distortion to allocative efficiency. As practicable, this approach involves endeavouring to set prices for each service at a 'mark-up' above the marginal costs. The mark-up is required to contribute to both the total incremental costs of that service as well as the common and fixed costs, but to do so with the least reduction in the level of use of that service. The term 'incremental costs' is used here to refer to the cost which are directly associated with providing a particular service.

In implementing its pricing, Airservices is obliged to relate its prices to its three main functional services—en route navigation, TN and ARFF—and to the different levels and nature of these three services, i.e. by location.

Airservices' location-specific pricing approach involves setting prices for services based on the costs attributed to providing a particular service at a particular location. These costs include the incremental costs of providing a service at that location (opex and capital costs) and a contribution to common costs. Airservices sets prices to recover the costs of providing TN and ARFF services at a location by levying a user

charge based on tonnes landed at that airport. For en route services, Airservices sets prices on the basis of aircraft weight in tonnes (for aircraft weighing more than 20 tonnes, the square root of the weight is used) multiplied by the distance travelled divided by 100.

For example, in 2004–05 a Boeing 747-100 (weighing 324 tonnes) landing at Melbourne airport would face both an ARFF charge of $411.48 ($1.27 per tonne) and a TN charge of $1305.72 ($4.03 per tonne). The en route charge for the same jet, travelling between Brisbane and Melbourne airport (the great circle distance between the two airports is 1266 kilometres[32]) would be $1007.23 ($4.42*(1266/100)*√324).

The full schedule of Airservices' charges is listed in Table 1.1 in Part A of this document.

In applying a location-specific pricing approach, it is important from an efficiency perspective that the basis of pricing closely reflects the cost that Airservices incurs as a result of providing a particular service at a particular location. If, for example, the number of tonnes landed at a location bears no relationship with the costs that Airservices incurs as a result of providing a service at that location, the price users pay will not meet the costs incurred in meeting their demand, and allocative efficiency may be undermined.

Airservices' approach to costs and pricing, and its method of allocating common costs is discussed in more detail below. Airservices' approach to determining the capital cost at a particular location is discussed further in the building block methodology section of this document.

In its 2003 decision the ACCC considered three aspects of Airservices' structure of pricing:

- relativities between en route charges, TN charges and ARFF charges
- relativities between TN and ARFF charges at different locations
- relativities between the prices charged to different users.

In 2003 the ACCC noted that, even with the proposed price increases, TN and ARFF services were still expected to make a loss, while the en route service was expected to make relatively high returns. The ACCC therefore considered that the approach of increasing the prices of TN and ARFF services, while not increasing the price of the en route service, was an appropriate approach to rebalancing charges while increasing revenue.

In relation to the second aspect of pricing structure, the ACCC considered that the decision to seek essentially uniform increases in TN and ARFF services seemed reasonable, considering that most locations would continue to operate at a loss even with the proposed price increases.

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[32] Less 110 kilometres for both aerodromes.

The ACCC noted that many of the concerns expressed by users appeared to arise as a consequence of a lack of transparency regarding the level of information about the costs of providing TN and ARFF services at particular locations. The ACCC therefore encouraged Airservices to increase the level of transparency in its costs.

With respect to the third relativity, of the prices charged to different users at a particular location, submissions to the ACCC in this process submitted that larger aircraft were penalised as a result of Airservices charging on a tonnage basis. Some submissions argued that Airservices should consider passenger based charging for ARFF and TN services on the basis that this may better align prices with the cost drivers of those services.

The ACCC noted those views regarding the use of tonnage and passenger based charges and suggested that there may be scope for some improvement in Airservices' price structure—in particular, to better align prices faced by users at particular locations with the drivers of Airservices' costs. The ACCC encouraged Airservices to consider alternatives to its current structure of prices.

Airservices changed from full network pricing to a location-specific based approach for ARFF services in 1997, and for TN services in 1998 as part of its 'business transformation' program in which it sought to improve the efficiency of its operations.

To alleviate the impact of the higher prices involved in transitioning from a network to a location-specific pricing approach, the government capped prices for TN services at some regional and GA airports, and introduced a direct subsidy. For the last year (2003–04), this direct subsidy contribution amounted to $7 million.

In 2003–04, Airservices estimated that it under recovered TN costs at 16 airports. While the under recovery of costs was offset partly by the government subsidy, Airservices estimated that even with this subsidy it would incur a shortfall of $10 million.

It was announced in the May 2004 federal budget that the annual government subsidy of $7 million for regional and GA TN services will expire on 30 June 2005. In addition, the Minister for Transport issued a Direction under the AS Act that restricts price increases to a maximum of 16.8 per cent at capped locations in 2004–05. However, from 1 July 2005, the price caps will no longer apply.

9.1.1 Airservices' proposed pricing path

Airservices' pricing proposal seeks a weighted average price increase of 5.2 per cent in 2004–05 (2.8 per cent in real terms), which includes the provision of new upgraded ARFF services under recently mandated regulatory changes. The nominal weighted average price increase in the absence of these effects is 4 per cent in 2004–05. Airservices proposes that overall prices increase by approximately 1.7 per cent over the next four years, or reduce in real terms. These price changes are again outlined in Table 9.1:

Table 9.1: 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%
En route	-5.2%	-1.1%	-2.5%	-0.9%	-0.9%	-10.3%
Weighted average **[incl. new services]**	**4.0%** **[5.2%]**	**1.3%**	**0.0%**	**0.4%**	**0.0%**	**5.8%**

Airservices submits that its proposed pricing path features:

- a revised cost allocation methodology for overhead and 'distributed costs' based on aviation activity levels which takes into account users' capacity to pay
- the adoption of a 'basin' concept with respect to GA aerodromes situated in capital city locations
- 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.

9.1.2 *The ACCC's approach*

The ACCC's assessment of the structure of prices in Airservices' pricing proposal separately considers the features of Airservices' proposed pricing path in turn: cost allocation; basin pricing; timing; and pricing across services and user groups.

Airservices' approach to allocating distributed costs

9.1.3 Airservices' position

Distributed costs are composed of specialist support, group and corporate overheads. In previous pricing proposals, Airservices has used an activity-based costing (ABC) approach to allocate distributed costs across service lines and to locations.

The application of this method of allocating costs between services and airports in Airservices' initial pricing proposal was a significant factor behind the resultant proposed price increases in excess of 1000 per cent for some services at some locations. Airservices states that this was developed to support location-specific pricing in accordance with a 'user pays' philosophy, to support capital investment decision making and to prepare for the introduction of competition for its services.

Airservices submits that the considerable concern expressed by GA operators demonstrated that pricing predicated on the basis of this methodology would be untenable and cause widespread dislocation to significant and vulnerable sectors of the industry. As a result, Airservices adjusted its approach to allocating distributed costs towards one that takes into account users' capacity to pay.

Airservices continues to use its ABC approach to allocate distributed costs to its service categories (en route, TN and ARFF). This approach involves using various different measures of activity to apportion costs between services. Table 9.2 sets out the elements of Airservices' distributed costs, the measures used to allocate costs between service lines, and the percentage allocation of these costs that are directly attributable to service categories.

For example, of the total cost of ATS training for 2003–04, 44 per cent is directly attributable to en route, 7 per cent is attributable to TN and the remainder is allocated between en route and TN services on the bases of trainee numbers and ATC head count.

Table 9.2 Distributed cost allocation for 2003–04

Distributed costs by item	Measure used to allocate costs	En route %	TN %	ARFF %	Comments about allocation
ATS planning and procedures	Operational staff costs		21		En route and TN
Australian flight information centre	Flightwatch & Briefing direct to en route, the rest on airways revenue	79			En route and TN
ATS training	Trainee numbers and ATC head count	44	7		En route and TN
ARFF training	Trainee numbers and ARFF head count			100	ARFF
Operational system and asset support	Combination of assets and future capex				En route and TN
Static data management	Operational staff costs				En route and TN Approach
TAAATS flight data coordinator	Operations staff costs, and # of consoles				En route and TN approach
NAS project	En route	100			En route
Aeronautical information management	Operational staff costs				En route and TN Radar
Quality assurance and safety	Operational staff costs				All

Allocated property and insurance cost	Operational staff costs				En route and TN approach
Noise inquiry (in Melbourne Brisbane and Sydney)	Operational staff costs		100		TN approach
ARFF operational support	Staff numbers			100	ARFF
Airport service group management, HR, finance and admin support	Staff numbers				TN Tower and ARFF
ATM group management, HR, finance and administration support	Staff numbers				En route and TN approach
Corporate services and business systems	Total direct expenses				All
Head office	Total direct expenses				All

However, Airservices now allocates the distributed costs allocated to TN and ARFF services to locations (at which those services are provided) in proportion to the number of tonnes landed at those locations. As en route is priced as a single service, there is no further allocation of distributed costs.

Table 9.3 illustrates Airservices' costs categories, and describes the method of cost allocation:

Table 9.3 Cost category breakdown

Type of cost	Proportion of regulated service costs	Method of allocation
Direct costs	42%	Directly attributed to a particular service and location. This includes the air traffic controllers and fire fighters at particular locations, and supplier costs incurred at a particular location for a specific service.
Shared services	3%	Allocated to services and locations based on activity and usage. These costs include non-operational communication and data services, transaction processing, and information management services.
Asset cost—facility management and maintenance	15%	Allocated on ABC principles using technical maintenance scheduling software applications. These costs include management and maintenance of the radars, navigation aids, communication networks and software making up the airways system.
Asset cost—direct depreciation	9%	Where an asset is fully dedicated to a service at a particular location, depreciation associated with that asset is costed directly to the relevant service and location. (Depreciation relating to shared assets is captured in Distributed costs and allocated accordingly.)
Distributed costs	31%	Allocated to service lines using ABC principles, as outlined in Table 9.2. Once allocated to service lines, distributed costs are allocated to locations (at which those services are provided) in proportion to the number of tonnes landed at that location to total tonnes landed..

Airservices notes that, within each service line, 'distributed costs' tend to be fixed relative to the operation of regional and GA towers and ARFF services. Airservices submits that if these services were withdrawn, distributed costs would largely continue to be incurred.

Airservices contends that, because distributed costs would not be proportionately reduced if a number of locations were closed (i.e. they are relatively fixed), it considered it to be reasonable to spread these costs to individual locations based on capacity to pay.

Further, Airservices submits that while there is no empirical evidence available, Sydney, Melbourne, and Brisbane are considered to have relatively inelastic demand responses to changes in Airservices' pricing. Airservices concludes that the outcome of using tonnes landed as an objective cost allocation basis transferred costs from all

other locations to these three locations to reflect their capacity to pay for a higher share of these costs.

Airservices submits that its revised approach to allocating distributed costs to locations recognises that smaller GA and regional locations should continue to contribute towards fixed costs, but at a significantly lower level than in the past. Airservices states that a proportionately higher level of these costs will be recovered from Sydney, Melbourne and Brisbane users.

9.1.4 Views of interested parties

The ACCC's issues paper sought comment on whether Airservices' approach to allocating common costs was appropriate.

Some submissions contended that Airservices' approach to allocating common costs on the basis of users' capacity to pay was inappropriate.

In addition, some submissions considered that Airservices' approach to cost allocation further burdened RPT airlines with costs that are properly attributable to regional and GA airlines, and as such hid the degree to which regional and GA services are cross subsidised.

BA strongly disagreed with the re-allocation of indirect costs on a 'capacity to pay' basis. BA believes that 'ability to pay' is not a concept that should apply to charging for air traffic services. Furthermore, ability to pay is not used in any other part of an airline's cost base and BA believes that ability to pay is an outdated principle that should no longer be used.

BARA contends that the end result of Airservices' change in methodology for allocating indirect costs is merely to disguise the cross-subsidy of regional and GA users by major airlines.

Qantas submits that Airservices' change to its approach to allocating overhead and distributed costs on a capacity to pay basis hides the cross-subsidy by shifting costs away from regional and GA users.

Virgin Blue contends that there is no economic justification for Airservices' proposed approach to allocating indirect costs using a methodology based on activity that takes into account users' capacities to pay. Virgin Blue notes that as a result of this, a proportionately higher level of these costs will be recovered from Sydney, Melbourne, and Brisbane users—routes where Virgin Blue primarily operates. Virgin Blue submits that the past conventional activity based costing approach to distribute joint and common costs to service lines should be maintained.

The Jandakot Airport CC contends that, from a GA point of view, using primarily General Aviation Aerodrome Procedures (GAAP) and secondary airfields, GA's true share of indirect costs is well under its share of total tonnage operated. In other words, it submitted that most of the indirect costs are incurred for the benefit of RPT operators, not GA.

Other submissions considered that Airservices' approach to allocating distributed costs was appropriate.

The Gold Coast airport contended that the proposed method of cost allocation appears to be appropriate in view of the negative effect that the increases in costs will have on certain classes of operator and on the airports that service them.

Submissions also questioned whether Airservices' approach to allocating distributed costs did actually take into account users' capacity to pay.

SMABC submitted that there are arguments to support the use of tonnes landed as the basis for cost allocation, but this measure does not accurately reflect GA's capacity to pay.

SMABC submitted that costs should be allocated to TN services supplied at basin airports on a basin approach.

SFC noted that, while the use of tonnes landed provides a reasonably equitable distribution when applied to larger aircraft, it produces some inconsistencies when applied to aircraft at the lower end of the scale. SFC notes that assuming that each aircraft had all seats occupied, the approximate cost per passenger landing at Sunshine Coast airport would be:

Airbus A 320	$9.95 per pax
Boeing 737-700	$11.80 per pax
Metro 111	$7.95 per pax
Lear 45(Charter)	$31.40 per pax
Lear 45 (training 2 students)	$110 per student
Bolkow Helicopter (search and rescue/ambulance)	$60 per flight
Cessna Citation ferried for maintenance	$220 per flight
Hawker Hunter (Historic aircraft/airshow performances)	$220 per flight.

SFC submits that these distortions may be further exacerbated by the fact that smaller aircraft generally operate over less popular routes serving smaller communities, and are therefore less likely to achieve high load factors, effectively increasing the cost per passenger for these operations.

SFC contended that a more equal distribution could be achieved by applying a cost per paying passenger. It submitted that this would achieve a more equal distribution and hence would apportion costs directly in relation to income earned and hence ability to pay.

9.1.5 ACCC view

It appears to the ACCC that Airservices' 'distributed' costs which have been allocated to service lines are in the nature of common costs to those services and there is no clear (causal) basis for apportioning these costs between locations.

With no causal basis for apportioning common costs to locations, appeal needs to be made to an economic principle that would result in an efficient allocation of the common costs.

As noted by the ACCC in its consideration of Sydney Airport Corporation Limited's aeronautical pricing proposal ('Sydney Airport pricing proposal') in 2001, one method that can be used to allocate common costs is based on Ramsey-Boiteux pricing principles. In this case, the question of how common costs should be allocated is equivalent to the question of how these costs should be recovered from users ('the Ramsey-Boiteux method of cost allocation').

Under certain circumstances,[33] this method of cost allocation suggests allocating costs to services and locations in inverse proportion to the elasticity of demand for the service (the inverse elasticity rule) will maximise economic efficiency.

Airservices' approach to allocating common costs to locations for ARFF and TN services appears in several respects to be broadly consistent with the inverse elasticity rule.

Allocation of costs to locations based on proportion of tonnes landed results in high activity locations, such as major metropolitan airports, being allocated a greater proportion of common costs. Thus, the efficiency of this approach hinges on the extent to which the users at these locations have, in broad terms, relatively inelastic demand for Airservices' services.

In its report on the Price Regulation of Airport Services released in January 2002, the Productivity Commission (PC) assessed the price elasticity for Australian airports' services in the context of providing indicators of the degree of market power of different airports.

In this report, the PC found that Brisbane, Melbourne, Perth and Sydney airports had a high degree of market power because they faced relatively low substitution possibilities. The PC also considered that Alice Springs, Coolangatta, Hobart and Launceston airports were likely to possess the least degree of market power as they, among other things, faced a high degree of destination substitution.

Given the major hub and core attractor role of these locations, and the lack of close substitutes for airline users, in general, for most users their demands will be relatively price inelastic.

In addition, given the broad correlation between tonnes landed and passenger numbers, allocating the common costs between locations on the basis of tonnes

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[33] The Ramsey-Boiteux method of cost allocation involves allocating common costs between users with the objective of maximising efficiency. In circumstances where demands for services produced by a multi-product monopolist are independent (i.e. where the cross-price elasticities of demand are zero), allocating common costs in inverse proportion to various users' price elasticities of demand will maximise economic welfare. See J Vickers, 'Regulation, Competition and the Structure of Prices', Oxford Review of Economic Policy, Vol 1, # (?)

landed results in a greater proportion of distributed costs being covered by a relatively lower per passenger equivalent charge.

The ACCC notes that Airservices' method of cost allocation is one which is reasonably likely to result in allocations which broadly reflect users' capacity to pay.

However, the ACCC is unable to determine how good a proxy to the inverse elasticity method Airservices' approach is, and hence the degree to which it will serve efficiency, because:

- the ACCC does not have detailed information about the demand elasticities of Airservices' users
- it is not clear that demands between locations are independent.

Having said that, the weight of qualitative argument suggests that Airservices' approach of using activity measured in tonnes landed to allocate common costs to locations for TN and ARFF services is a reasonable and transparent approach to cost allocation.

Application of the 'basin concept' in setting prices for TN services

9.1.6 Airservices' position

In its 2004 price notification, Airservices has applied a 'basin concept' in setting prices for TN services for airports located in major capital city metropolitan regions.

Airservices states that the basin concept was raised through the industry consultation process as an appropriate means of spreading the costs of airports co-located within the major capital city areas.

This approach to pricing TN services for airports in major basins broadly involves setting prices to recover TN allowable revenue at all airports within a basin for TN services, in lieu of setting prices to recover allowable revenue at each individual airport.

In particular, Airservices has advised that in applying this approach, it has increased prices at secondary airports within basins by 16.8 per cent in the first year. This is to reflect the 'catch up' for the last six years in line with the ministerial direction on the increase to the price caps applying for TN services at particular locations. Airservices has then proposed price increases at secondary locations of 10 per cent per annum for years two to five of its pricing proposal.

The prices at the primary locations were then increased so that revenue from all locations in the basin equated to the estimated allowable revenue for the locations in the basin in year five.

Because secondary airports are generally under recovering costs allocated to them by Airservices, the application of the basin concept in setting prices for TN services results in prices higher than costs at primary airports, and lower prices at secondary airports.

The basin concept is based on the 'inherent interdependency that exists between the operations of these airports, where the existence of the secondary location has a significant positive impact on reducing congestion at the major basin airport'.

Airservices submits that the 'basin concept' is underpinned by:

- **an historical basis***:* Pressure on the primary airports during World War II saw the government provide financial incentives for training and private operators to move to secondary airfields.

- **an impact on runway capacity***:* An increase in the number of light aircraft at major metropolitan airports would reduce arrival and departure rates. Airservices estimates that movement rates, and slots, could reduce by considerably more than 10 per cent at peak periods if this relocation occurred.

- **shared management of operations***:* There is a significant level of shared resources between basin airports. These shared resources utilise the same terminal area approach and departure radar service to prioritise traffic in and out of these airports.

Airservices states that, while a clear interdependency exists between the locations in a basin, part of the cost structure is required to service operations that would not necessarily relocate to the major airport should the secondary aerodrome not exist. Airservices submits that it is therefore appropriate to maintain a higher price at the secondary location.

Airservices submits that this principle has been established after extensive consultation with the major airlines, whose costs would increase as a result of this approach.

Airservices has provided further information to the ACCC about the extent of shared resources between primary and secondary airports within basin areas. Airservices submits that basin airports share a common radar approach service and navigation aids.

The radar approach service comprises air traffic controllers (separate from those providing services in the tower) and radar surveillance facilities dedicated to providing a control service for traffic approaching and departing the aerodromes in the basin. As the approach service is not used by the majority of aircraft (eg, circuit training) at the secondary location, the full cost of the approach service is applied to the primary airport.

Because navigation aids are primarily used as TN aids for the particular airport in which they are located, Airservices allocates the full cost of the navigation aids to that airport. In addition, the primary locations and Essendon use one or more instrument landing systems (ILS), which cost (in terms of maintenance and depreciation) around $350,000 per annum to operate. Airservices submits that, while some components of the ILS at Essendon are used by operations into Melbourne airport, the primary purpose of the ILS is for operations into Essendon airport.

9.1.7 Views of interested parties

The ACCC's issues paper sought comment on the appropriateness and efficiency of the application of the basin concept in setting prices for TN services at airports in capital city basin areas.

Generally, domestic and international airlines did not agree with Airservices' application of the basin concept in setting TN prices. In particular, BARA, Qantas and BA contended that Airservices had failed to provide any evidence to support its claims that interdependencies exist between airports located in basin areas.

BARA, BA, Cathay Pacific, and Singapore Airlines also argued that Airservices' application of the basin concept in setting prices for TN services hides the degree to which services are subsidised and results in international and domestic airlines bearing a greater proportion of costs.

BARA submits that Airservices has failed to provide any evidence to support the proposition that an interdependency exists between city basin airports. BARA submits that the basin approach:

- undermines and unwinds the efficiency and transparency benefits obtained with the recent adoption by Airservices of location-specific pricing
- encourages unwarranted expenditure and cost inefficiency at the subsidised locations.

Further, BARA argues that location-specific pricing is an appropriate methodology for charging for TN services, and that if the government should decide that a subsidy for regional TN services is justified, then the subsidy should be transparent and funded from consolidated revenue.

BA and the DPIWA submit that Airservices' application of the basin concept in setting prices for TN services in basins affects the ability of airports to realise economies of scale.

BA believes that such a pricing policy gives incorrect pricing signals to the market and prevents airlines benefiting from the economies of scale they have helped to create.

Qantas does not agree with Airservices' contention that, where a secondary airport were not to exist or be too expensive, there would be increased small aircraft traffic at major metropolitan airports which would lead to increased congestion at the major metropolitan airport. Qantas suggests that in this scenario light aircraft operations would re-distribute to non-controlled aerodromes within the greater basin area. In addition, Qantas contends that increased light aircraft traffic at major metropolitan airports would not necessarily result in increased congestion, because existing congestion management systems at major metropolitan airports are designed to prevent such an outcome.

Although there is a degree of support for the application of the basin concept in setting prices for TN services, there was concern amongst submissions that the prices for the same services between basin airports were not the same.

Archerfield airport notes that it has a reliever function that complements Brisbane airport's ability to service the large business end of the industry. Archerfield airport states that 'even though we are two separate companies providing airports, our colleagues at Brisbane call us their greatest asset as we relieve them of small aircraft operators.'

Linfox contended that Airservices completely over services Essendon airport. Linfox noted that, while Moorabbin airport undertakes 300 per cent more air traffic than Essendon airport, there are presently only 70 hours of air traffic control at Moorabbin airport and 108 hours at Essendon airport. Linfox submitted that there is no commercial or operational reason to provide this additional coverage, perhaps other than to support Melbourne airport's operations. Linfox submitted that Melbourne airport also makes use of navigational aids at Essendon airport.

Further to this, Linfox provided the ACCC with a copy of a letter addressed to it from Melbourne airport in relation to Essendon airport's preliminary draft master plan. In this letter (a copy of which is available on the ACCC's website), Melbourne airport states, 'The issue of continuing over flights of Melbourne bound aircraft is also relevant to the future use and siting of the localiser navaid for the Essendon east-west runway. This localiser is used by aircraft approaching Melbourne and hence will need to be retained.'

The RFDSW questions Airservices' approach to the allocation of Terminal Control Unit (TCU) charges. The RFDSW submits that the TCU provides an approach control service to all airports in the Perth area, including the military, not just Perth airport itself and should not be described as a cost that is location specific. The RFDSW submits that this cost would more appropriately be applied network wide, in the same way as en route charges.

The Rockhampton CC contends that Airservices does not recover from the Australian Defence Force (ADF) the costs associated with the provision of ATC or ARFF to the Australian Defence Force at Rockhampton airport. The Rockhampton CC estimates that these charges are approximately $240 000, which are passed on to domestic aircraft operators. The Rockhampton CC submits that the ADF currently provides ATC and ARFF services at Newcastle airport. It submits that as a result of the lack of a clear charging regime for these services, commercial advantage is given to domestic aircraft servicing this port. The Rockhampton CC notes that this results in a price differential of $14 per passenger when compared with Rockhampton airport.

SFC submits that the proposal would appear to provide an incentive for aerial work operations that do not involve travel from one location to another (maintenance, training, search and rescue etc) to relocate to major airports, where charges are lower. SFC submits that this is likely to have an adverse impact on the operation of major airports, and the surrounding environment.

Mackay PA contends that RPT operators at regional airports suffer similar delays when a jet aircraft has to hold and wait for a light aircraft approaching for a touch and go as landing aircraft have precedence over departing aircraft.

Rockhampton CC submits that it is unable to determine why Airservices does not levy ATC charges for other airports that make use of its navigation facilities. For example,

Prosperine airport has three navigation aids servicing several instrument approaches at this airport, yet an ATC charge is not levied on aircraft operating from this airport.

A number of submissions including the Archerfield airport, Jandakot Airport CC, Canberra airport, Jandakot airport, Linfox, SFCJ and DPIWA raised concerns that Airservices' application of the basin approach resulted in different prices for the same services in the same basin, and this would affect competition between locations.

Linfox submits that a proper basin charge would mean that all TN and ARFF charges in the Melbourne region, covering Essendon, Avalon, Moorabbin and Melbourne airports, would be the same. Linfox contends that Essendon airport competes against Melbourne airport for corporate jet based activity, whilst Avalon airport has recently entered the RPT market with passenger flights. Linfox considers that Airservices' monopolistic pricing will provide a severe difference in pricing for Essendon airport and Avalon airport based customers and will likely strengthen Melbourne airport's powerful market position.

SFCJ argues that the basin approach to pricing creates a situation where GA airports end up paying more for less. SFCJ points out that running its business out of Perth International Airport would save $138 803.28 per annum.

The DPIWA submits that although the basin approach provides significantly lower prices for GA airports, it presents a number of problems for WA:

- After five years there will be a significant variance in price between Perth and Jandakot airports and Perth airport does not present as an alternative to Jandakot airport for operators affected by the increased costs.
- It is more likely that activity will migrate to non-controlled airfields, putting greater price pressure on the operators remaining at Jandakot airport, and reducing safety in WA.
- Perth airport, as the sole international airport in WA, competes for international services with international airports located on the eastern seaboard. Perth is disadvantaged under the current proposal, with its prices being significantly higher than Brisbane, Sydney and Melbourne airports.

9.1.8 ACCC views

Where interdependencies that Airservices has outlined exist between airports situated in the same basin, and where there is a significant level of shared resources between basin airports, there appears to be merit in taking into account these factors in Airservices' pricing structure.

There is support in submissions for Airservices' contention that interdependencies exist between airports located in basins. In particular, Archerfield airport considers that Archerfield airport has a reliever function that complements Brisbane airport's ability to service the large business end of the industry.

In addition, Linfox contends that Essendon airport would not need air traffic control services in the absence of Melbourne airport, and that air traffic inbound to Melbourne airport makes use of navigation facilities at Essendon airport. Linfox

therefore submits that these facilities are inappropriately reflected in Essendon airport's cost structure.

However, although some submissions are supportive of the use of the basin concept in setting prices for TN services, they express concern about the differential pricing in Airservices' proposal. In particular they submit that where airports in the same geographic area compete for particular air traffic, differential pricing can influence competitive outcomes.

On this issue, Airservices submits that where a clear interdependency exists between the locations, part of the cost structure is required to service operators that would not necessarily relocate to the major airport should the secondary airport not exist. It therefore concludes that it is appropriate to maintain a higher price at the secondary location.

The ACCC does not consider that taking into account interdependencies and shared management of operations should necessarily result in a common price applying to all airports located within a particular basin. Rather, the application of the basin concept in setting prices for TN services should make appropriate adjustments to prices to reflect those interdependencies and shared resources.

It appears that Airservices' method of cost allocation in respect of the shared resources of radar approach and navigation aids results in an allocation which broadly reflects the use of this equipment. The qualifications to this are:

- To the extent that the radar approach service is used by aircraft at secondary locations, these users would not be contributing to the costs of providing the service.

- To the extent that navigation aids at a particular airport are used for planes landing at another airport, these users would not be contributing to the costs of providing the service.

- In the case of the ILS at Essendon airport, to the extent that it is used by operations into Melbourne airport, users at Melbourne airport would not be contributing to the costs of providing the service.

However, it appears that these effects are not significant in their effect on regional airports because the navigational aids (and ILS at Essendon) are primarily used at the regional airport in which they are located, and the relative magnitude of these effects is overtaken by the effect of the basin approach to pricing in limiting the revenue collected from secondary locations. In the case of Essendon airport, even assuming that the allocated costs should be at the same levels of those for Moorabin airport, application of the basin approach to pricing still results in an under-recovery of such costs, in the order of $1.5 million per year, with these costs being recovered from users of Melbourne airport.

Due to the lack of information quantifying the demand-side interdependencies and the lack of quantification on the above three supply-side factors, the ACCC is unable to assess the extent to which the application of the basin concept in pricing for TN prices at capital city basin locations accurately takes these factors into account.

While the ACCC acknowledges that there are difficulties in quantifying the effects of the demand-side interdependencies between airports, it considers that Airservices should attempt to provide at least the order of magnitude of the various interactions by capital city basin and also indicate the order of magnitude of the price adjustments implied.

The ACCC sees potential merit in incorporating demand-side interdependencies (such as movement congestion in a common basin airspace) and would encourage Airservices to develop the estimation of the appropriate associated adjustment to charges. This would enable an adequate basis for the basin pricing concept to be assessed.

Timing of price increases

9.1.9 Airservices' position

Airservices submits that it is conscious of the potentially dislocating impact of large price increases, and notes the feedback from regional and GA operators who are particularly vulnerable to significant price increases.

This feedback called for increases to be phased in over a number of years, and in this proposal, price increases are restricted to a maximum of 16.8 per cent (in line with ministerial direction) in the first year, with later year increases restricted to a maximum of 10 per cent per annum.

Further, Airservices contends that by transitioning prices in this way over the five-year period, most TN and ARFF services will reach, or will be close to, full cost recovery.

9.1.10 Views of interested parties

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

BARA, Qantas, the Cairns PA, Mackay PA, RAAA, the SMABC and Virgin Blue supported Airservices' approach to phasing price increases over the five-year period.

SMABC submits that it appreciates the phasing in of price increases, because it considered that the GA sector is unable to absorb the total cost increase of the proposed magnitude in one or two years.

RAAA considers that the phasing in of prices in Airservices' draft price notification is better than the 'big bang' approach originally proposed.

Virgin Blue contends that while its preference would be to remove the cross subsidisation between en route and other services immediately, it is willing to accept the proposed timing of price increases on the basis that Airservices is proposing a phased in rate of return.

SFCJ acknowledged that there would be price increases to allow operating costs to be met, but argued that bringing charges to a point of meeting those costs should be a

gradual process. It submitted that once the cost recovery has been reached any increases should be in line with CPI.

However, some submissions expressed concern that the phasing in of price increases in Airservices' proposal was front loaded.

RVAC and the VRAC submit that there is no reason for the first huge increase, and that the total increase should be spread evenly over the five years. Alternatively there could be a half-annual increase in January, followed by full annual increases in July of each subsequent year.

The Jandakot Airport CC and Jandakot airport submit that the front loading of price hikes in inequitable.

Linfox does not support the phasing in of the proposed price increases unless they are uniform, and phased in consistently across all airports.

Some submissions, including the RFDS, contended that it was not clear whether the increase in prices would cease at the end of Airservices' pricing proposal.

Maroochy SC submits that the phasing in of TN price increases is satisfactory, but considers that the increase in ARFF charges also needs to be phased in.

9.1.11 ACCC views

As noted in the earlier discussion of opex, there are substantial increases in estimated costs in the first year of Airservices' pricing proposal, in part resulting from increases in staff costs and the provision of new ARFF services. Airservices has also adjusted the relativities in prices for its services, in an attempt to reduce the levels of cross-subsidy between service lines.

The ACCC considers that increasing prices to more accurately reflect costs, where those costs are efficiently incurred, should promote allocative efficiency. However, where this results in substantial price increases that were not advised nor reasonably anticipated, it is necessary to consider the imposed costs of such action, in terms of the potentially dislocating impact that such price increases could have on users, and to examine the timing of price increases. The notice period given in advance of price increases taking effect is also relevant in this assessment.

The ACCC considers it appropriate that Airservices has adjusted its original approach of immediate adoption of full location-specific pricing, which would have resulted in price increases for some services at some locations in excess of 1000 per cent, to take into account the possible negative effects that this would have caused.

Airservices' approach to phasing in price increases, however, is still front-loaded as the largest increases in prices occur in the first period of the pricing proposal. This is in line with the ministerial direction announced in the May 2004 federal budget that restricts price increases to a maximum of 16.8 per cent at capped locations in 2004–05. The ACCC considers that such an approach, in moving to a closer alignment of prices with costs, may be appropriate when there is a large disparity between prices and costs.

An alternative approach would be to introduce uniform price increases (of 11.36 per cent) in each of the five years. This approach could be justified on the grounds of avoiding sudden large price increases, where the size of the price increase is unanticipated by users, in order that they have a longer period in which to adjust to the increased prices. In addition, to the extent that the use of facilities generally increases as traffic increases over time, it is generally appropriate for charges (or the rate of increase in charges) to increase as the intensity of use of facilities increases.

On balance, the ACCC considers that increasing prices to the new maximum price cap set by the government and announced in June 2004, in the context of estimated costs being significantly greater than this (which is noted below in the discussion of prices across services and across user groups), appears to the ACCC to be a reasonable approach.

Pricing across services and user groups

9.1.12 Airservices' position

Airservices submits that, at current prices, the en route service is set to over-recover its costs by approximately $22 million, while TN and ARFF services would under recover their costs by more than $60 million.

Airservices contends that its proposed price changes (reductions in en route prices and increases in TN and ARFF prices) should promote the general economic health of the industry by, among other things, avoiding cross subsidising the cost of other services. Airservices submits that its pricing proposal has a significant impact in removing cross subsidies between service lines and accords with international practice and International Civil Aviation Organisation (ICAO) guidelines.

Airservices notes that alternative pricing structures, such as passenger and movement based charging, have been suggested in the past and states that it will continue to explore:

- passenger based charging for ARFF services
- movement charges at GA locations
- navaids only charged to users of the aids.

9.1.13 Views of interested parties

In its issues paper, the ACCC sought 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 sought comment on whether the proposed prices provide appropriate incentives for both Airservices and users to provide appropriate services at particular locations.

Qantas, IATA and Virgin Blue expressed concern about the degree to which services and locations are cross-subsidised in Airservices' pricing proposal, and expressed the view that these subsidies should be funded by the government.

Qantas notes that Airservices has been unable to achieve first best pricing for locations and services because the government does not intend to fully meet the degree of cost under recovery for some services and locations.

However, Qantas submits that Airservices has been able to reduce the degree to which services and location are subsidised through:

- increasing prices at regional/GA locations
- reviewing towers with low traffic levels
- reviewing the need for non essential en route services.

IATA submits that any shortfall in revenue should be fully funded by the government, either by providing the full amount of the shortfall in revenue to Airservices or by agreeing to seek a lower dividend from Airservices' profits in line with the revenue gap.

On the other hand, Linfox considers that the concept of cross subsidies is misguided. It argues that air traffic control is in place at all airports to protect airspace issues and the travelling public. In particular, Linfox contends that air traffic control is used at Essendon airport to ensure that the travelling public using Melbourne airport is protected. Linfox contends that if Melbourne airport did not exist, there would be no air traffic control requirement at Essendon.

RAAA contends that, although there appears to be a degree of cross subsidisation by the major carriers on an aggregate level, this is to a degree misleading because major carriers are the primary drivers behind increases in costs, particularly with respect to ARFF services.

The RFDSW submits that the proposed TN charges represent a massive cross-subsidy to the flying training element operating at Jandakot. Currently these operators only pay for one landing during a circuit training session where typically six landings may take place.

A number of submissions[34] expressed concerns about Airservices' use of a location-specific pricing methodology. A number of these submissions suggested that a network pricing approach should be adopted.

Adelaide airport, Canberra airport, and ADG considered that, while location-specific pricing may be appropriate in the context of introducing competition into the

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[34] Adelaide airport, Aeromil, ADG, Canberra airport, Cairns PA, China Southern, Jandakot Airport CC, Jandakot airport, RFDS, RFDSQ, DPIWA, RAAA, Mackay PA, RVAC and VRAC.

provision of services, while this was not the case, location-specific pricing was not justified and was inequitable.

Adelaide airport submitted that it understood that all of the charges at Parafield are recovered from only about 40 per cent of the users as the other 60 per cent land at nearby airfields and are not captured by Airservices' charging net.

Adelaide airport argues that other pricing methodologies are more equitable, in particular, that network pricing brings out unfair influences from the heavy end of the industry, both airport and airline, to the detriment of the regional and commuter operators and airports.

ADG contends that location-specific pricing will severely disadvantage regional and outback Australia, particularly small GA users and that a network pricing approach should be adopted.

RVAC and VRAC note that the concept of network charging does not seem contrary to government policy. This seems to be a similar concept used by other government organisations. For example, Australia Post charges 50 cents to send a standard letter to anywhere in Australia, and Telstra is required to cap the cost of a local telephone call in all areas.

In addition, a number of submissions expressed concerns about Airservices' approach to charging for TN, ARFF and, to a degree, en route services, on the basis on tonnes landed.

International operators expressed concern about Airservices' approach of pricing on the basis on tonnes landed as they submit that the cost to Airservices of providing services is independent of the weight of aircraft.

BA argues that the cost to Airservices of providing air navigation services is independent of the weight of the aircraft. Airservices' charging formula uses weight and distance as cost distribution parameters, resulting in the international operators, which use larger aircraft over longer distances within Australian airspace, being burdened with a disproportionate share of the costs.

Aeromil, Maroochy SC and Sunshine Express submit that the operation of RPT services at Maroochydore airport has resulted in operators who do not require a high level of ARFF services paying for a high level of ARFF services, and that aircraft with less than 40 passengers should not be required to contribute.

Sunshine Express contends that it is been 'unfairly slugged' with the full costs to run a category 6 and 7 level ARFF service, when it only requires a category 4 level of attendance.

Sunshine Express submits that Airservices should charge for the provision of the ARFF service per passenger, in line with how the legislation calls for the provision of the service, and distribute the cost over the Australian Domestic Network, to make this affordable for regional airline operators.

Aeromil contends that small business operators in regional airports are being required to pay for ARFF services that they do not require. Aeromil contends that the new

ARFF service at Maroochydore airport is being introduced due to the increase in passenger numbers generated by Virgin and Qantas/Jet Star exceeding 350 000 passengers per annum.

The RFDS and RFDSQ consider that ARFF costs should be borne by the passengers for whom the service is required. RFDS submits that the burden should be shifted from those who do not require and mostly operate without ARFF, such as RFDS, to those that do by law require ARFF, the larger airlines.

Virgin Blue suggests that, as an interim measure, the local fire services be able to provide the services at this airport instead of having dedicated airport fire services. Virgin Blue submits that this would allow time to see if the level of growth in that particular port is sustained. Virgin Blue believes that this interim measure would maintain the current level of safety and security. However, Virgin Blue submits that passenger based charges are less efficient than weight based charges, and unduly penalise more efficient aircraft.

9.1.14 ACCC views

As mentioned above, in assessing the structure of prices in Airservices' pricing proposal, the ACCC considers the extent to which prices promote efficiency and equity.

The ACCC considers that three main issues are raised in this section:

- whether Airservices should apply a network pricing approach, or a location-based pricing approach
- whether Airservices' pricing proposal embodies cross subsidies
- the basis (per unit) of Airservices' charging.

(a) Network pricing verses location-specific pricing

A return to a network pricing approach, which is advanced by some parties, involves common prices for similar services provided at different locations, regardless of either different levels of costs at those locations or different levels of activity at that location. This approach is unlikely to advance either efficient or equitable outcomes. While the demands for services at different airports are to some extent inter-related, the services which Airservices supplies are not network services in the strict functional sense, as tends to be the case for electricity, telecommunications and gas transmission.

While a uniform pricing approach between locations may cause relatively small losses in allocative efficiency, given the relative inelasticity of demand of major airport users, network pricing may have negative consequences for productive efficiency. Productive inefficiency may be more likely to result at smaller locations if excessive expenditure by Airservices is not required to be recovered from the users at that location, but is instead funded by the revenue received from larger airports.

There is also an equity argument for requiring each location to be self-funding, so that customers are not required to pay more than the cost of providing the service to them.

The ACCC therefore considers that location-specific pricing can encourage productive efficiency at locations and has beneficial equity implications between users of Airservices' services.

(b) Cross subsidies

Some submissions, such as those from the larger passenger airlines, have expressed concern about the continuing levels of cross-subsidy implicit in the pricing of TN, ARFF, and en route services, and between locations in the pricing of TN and ARFF services.

In considering this issue, a starting point is to apply the methodology to determining whether cross subsidies are present in the prices of a regulated multi-product firm (which is subject to a break even constraint)[35] developed by G.R. Faulhaber.[36]

Faulhaber argues that 'if the revenues of a regulated enterprise just cover total economic costs, then all prices are subsidy free if the revenues of each service and each group of services is at least as great as the incremental cost of providing the service or group of services; equivalently, prices are also subsidy free if the revenues for each service and group of services is no greater than the stand-alone cost of that service or group of services.'[37]

In this context, the 'stand-alone' cost of providing a service where a firm provides multiple services is the cost of providing only that particular service. The 'incremental cost' of providing a particular service is the additional cost that the firm incurs as a result of providing that service in addition to its other services.

Faulhaber's methodology for testing for cross subsidies between services is based on the contestability of the services provided by the multi-product firm. Where there is scope for competitive entry, prices for services less than (average) incremental cost may act as a barrier to entry; and prices for services greater than (average) stand-alone cost may lead to inefficient entry.

The ACCC notes that although Airservices' services are not currently contestable, due to legal barriers, there is merit in testing whether Airservices' prices contain cross subsidies as one of the reasons for the move towards location-specific pricing was scope for competition, particularly for the provision of ARFF services.

Further, it can be argued that Faulhaber's methodology provides a check on the reasonableness or fairness of prices. If one group of customers is paying more than the stand-alone cost of the service that they receive then (in theory) that group would be better off if they could refuse to accept Airservices' services and provide that

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35 While this is true for Airservices, there are minor variations from this in individual years.

36 GR Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, American Economic Review, 65(5), December 1975, 966-977.

37 GR Faulhaber, *Cross-Subsidy Analysis With More Than Two Services*, August 2002, p. 1, 'http://rider.wharton.upenn.edu/~faulhabe/cross%20subsidy%20analysis.pdf'.

service for themselves. In contrast, if one group of customers is paying less than the incremental cost for the service that they receive, then it could be argued that this group is not 'paying their way'. Indeed, in this latter case, if the group's willingness to pay for the service exceeds the price that they are required to pay but falls below incremental cost, then it may be economically inefficient to continue to provide that service at all.

Table 9.4, below sets out how the ACCC has interpreted Airservices' cost categories, as described in the section in this document on Airservices' approach to allocating distributed costs.[38]

Table 9.4 Economic interpretation of Airservices' cost categories

Cost type	Economic interpretation
Direct costs	Incremental
Asset costs—facilities maintenance and management	Incremental
Asset costs—direct depreciation	Incremental
Shared services	Common to all services
Distributed costs	Individual cost items treated as incremental where specific to a particular service and treated as common to particular groups of services, as set out in Table 9.2.

Further, because in Airservices' proposal, assets are largely specific to particular services and locations, incremental costs include a return on capital. This is particularly so for ARFF services, where the primary assets such as fire trucks and

[38] Strictly, in conceptual terms, inputs and their costs are either directly attributable to a service (i.e. avoidable if the services as a whole is not provided) or joint (i.e. once provided for any one service are available equally and undiminished for all others). For example, the CEO, head office executive, and computer information systems are joint costs, while the costs of terminal radar are directly attributable to TN services—and may be termed part of the 'incremental cost' for that service. But, in practice, empirical difficulties arise in identifying all strictly joint and incremental costs—primarily due to the form of expenditure data (on inputs) and in establishing the relationship of those data to service outputs—on which prices are based. It may also be difficult to measure the 'core' joint costs. (For example, some overheads, such as the 'best' CEO and computer systems may be altered if one complete service, say ARFF, was to be dropped). Thus, in the ACCC's analysis involving Airservices' costs, there are many inputs that are used 'in common' across several or all services but for which the direct requirements (costs) cannot be comprehensively separated to specific services (e.g. certain training and administration activities). Accordingly, the term 'common costs' is applied to all costs that are not clearly directly attributable to specific services (including any measure used to charge for them).

fire fighting equipment are not used by Airservices in the provision of TN and en route services.

For the purpose of the following analysis, the ACCC considers that the stand-alone costs of a service are the relevant incremental cost, and common costs. As set out in Table 9.2, components of Airservices' distributed costs are specific to a particular service or to particular bundles of services, rather than being common to all three services. For the purpose of the following analysis, the ACCC has included those costs which are specific to a particular bundle of services in the stand-alone cost of those services.

In addition to assessing whether each service covers its incremental and stand-alone costs, Faulhaber contends that 'both the SAC (stand-alone cost) and IC (incremental cost) tests should be applied not only to each service individually, but to **all possible groups of services.'**[39] Further, Faulhaber states that '… anything that the enterprise assigns a separate price to can and should be treated as a different service'.[40]

Unfortunately, because Airservices sets prices for 45 separate services (17 ARFF services, 27 TN services, and an en route service), testing whether each possible combination of these services covers their incremental and stand-alone costs is computationally complex. However, the ACCC has tested whether each of the 45 services, and bundles of the service categories recovers both incremental and stand-alone costs.

Faulhaber also notes that the presence of cross elasticities between services may influence the results of the tests because the revenue collected from a particular service is not likely to measure the incremental revenues, '… since revenues from the other services may rise (if the service is a net complement) or decline (if the new service is a net substitute)'.[41] Further Faulhaber notes that '… if the commodities in question are substitutes, there may be prices which pass an incremental cost test and yet involve a cross-subsidy'.[42]

It would appear that there is scope for some services provided by Airservices to be substitutable in terms of location, for example, TN services at Melbourne airport could be substitutable for TN services at Moorabbin airport. Submissions to the ACCC have suggested that price differentials between airports may lead to operators moving between airports. This issue is discussed in more detail in the impact on end users section of this document.

Chart 9.1 demonstrates the extent to which the service categories in Airservices' pricing proposal are expected to recover incremental costs. The ACCC has calculated

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39 GR Faulhaber, *Cross-Subsidy Analysis With More Than Two Services*, August 2002, p. 1.

40 ibid.

41 GR Faulhaber, *Cross-Subsidization: Pricing in Public Enterprises*, American Economic Review, 65(5), December 1975, 966-977.

42 ibid.

a proxy[43] for 2003–04 as a point of comparison for the periods relevant to Airservices' pricing proposal.

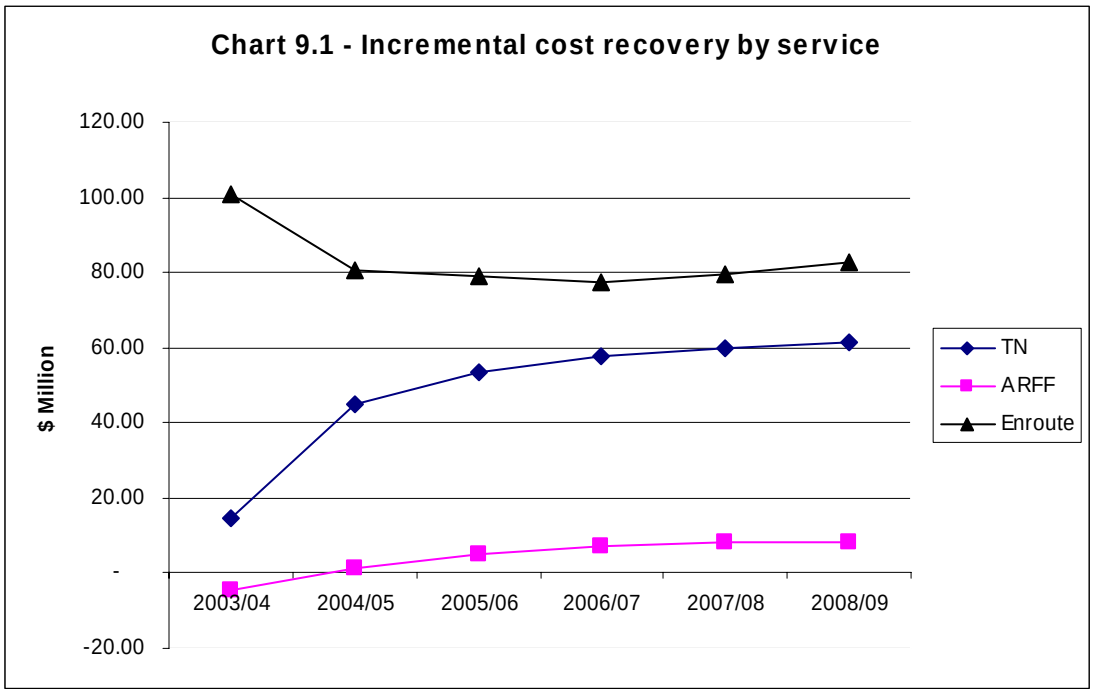

Chart 9.1 shows that each of the service categories in Airservices' pricing proposal are expected to recover incremental costs at proposed prices. While Chart 9.1 shows that ARFF services under recovered incremental costs in 2003–04, ARFF services are expected to increasingly recover incremental costs over the period of Airservices' pricing proposal. In addition, the ACCC found that each bundle of Airservices' three service categories are expected to recover their relevant incremental costs.

However, while the service categories are expected to recover incremental costs, not all services at all locations are expected to recover incremental costs.

Chart 9.2 separates TN services on the basis of location. The radar category includes all major metropolitan airports, and the navaids category includes the military airports at Darwin and Townsville. While Chart 9.1 demonstrates that combined TN services are expected to recover more than the relevant incremental costs, Chart 9.2 shows that revenue from regional and GA locations is not expected to cover incremental costs.

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[43] The ACCC was not provided with sufficient information to calculate allowable revenue for 2003–04, so a proxy has been used. The proxy is calculated from the written-down value of Airservices' assets for 2003–4, using the allocation of asset values between services and locations from 2004–05. Further, there was a small discrepancy in the quantum of distributed costs for 2003–04 in the information provided by Airservices. While the ACCC does not consider this would influence the results of the tests, the 2003–04 results should be treated with caution.

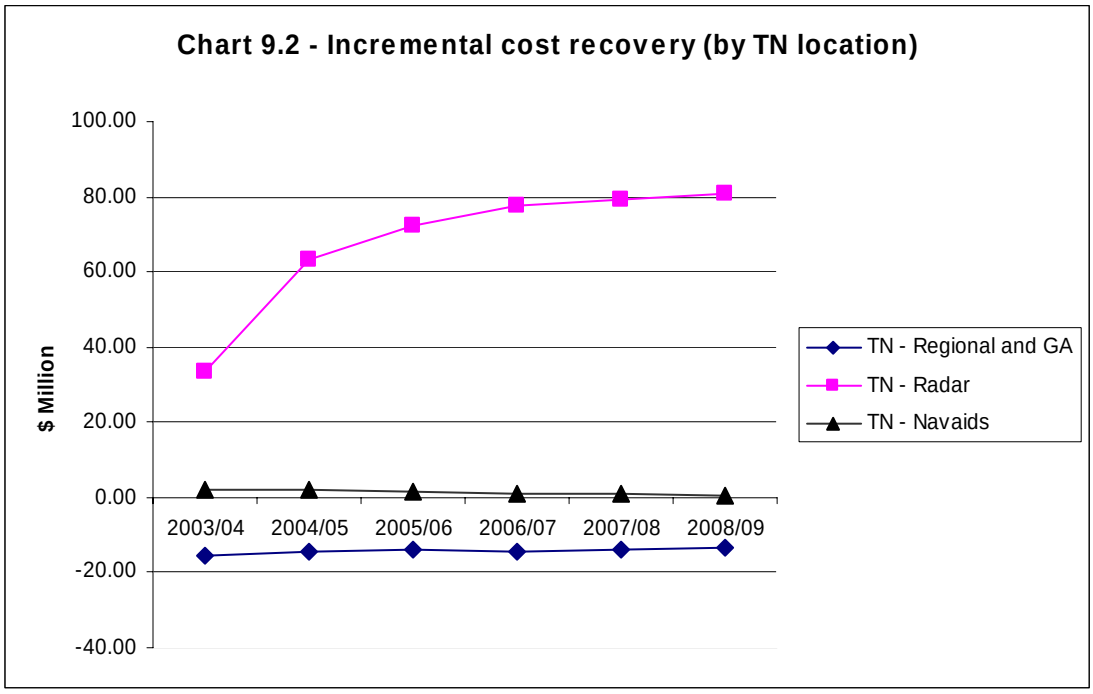
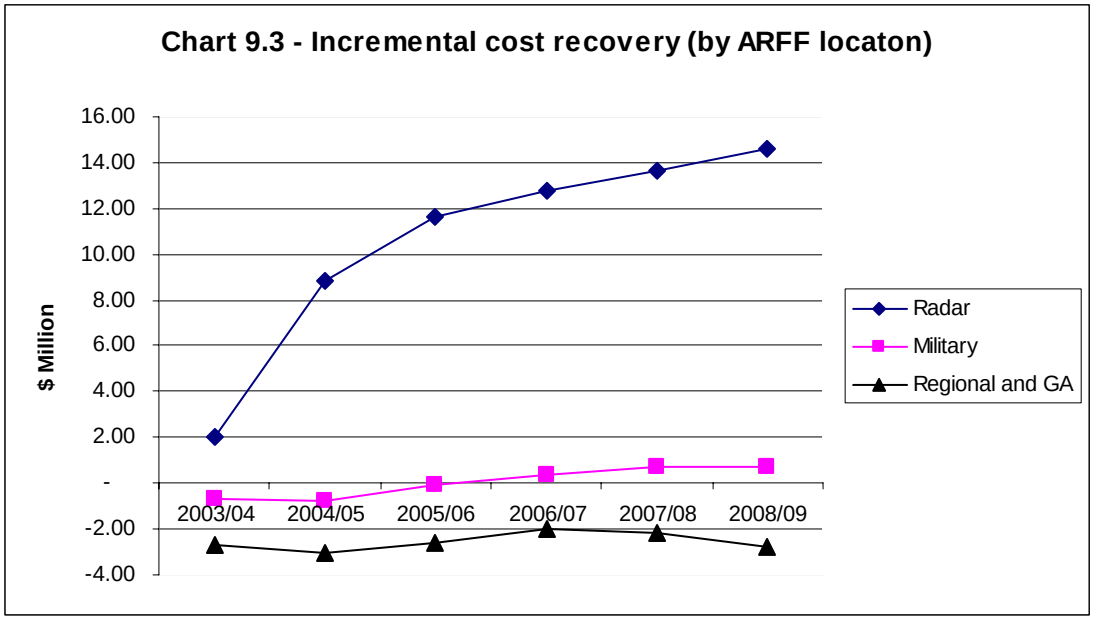


Chart 9.3 separates ARFF services on the basis of location. Chart 9.3 shows that while ARFF services at radar airports are expected to recover incremental costs for the duration of Airservices' pricing proposal, ARFF services at regional and GA locations are expected to under recover incremental costs for the duration of the pricing proposal. Further, ARFF services at military airports under recovered incremental costs in 2003–04 and are expected to under recover incremental costs in 2004–05.

However, while the radar category is expected to recover more than the relevant incremental costs and the regional and GA category is not expected to recover incremental costs, this is not necessarily the case for all airports within the respective categories. For example, Canberra airport is expected to under recover incremental costs between 2003–04 and 2005–06, while the new ARFF service at Ayers Rock airport is expected to recover more than incremental costs from 2004–05 to 2008–09.



The ACCC tested whether each of Airservices' services is expected to recover stand-alone costs. On an individual basis, each of Airservices' services is expected to recover less than the relevant stand-alone costs.

Chart 9.4 demonstrates the extent to which bundles of service categories are expected to recover stand-alone costs.

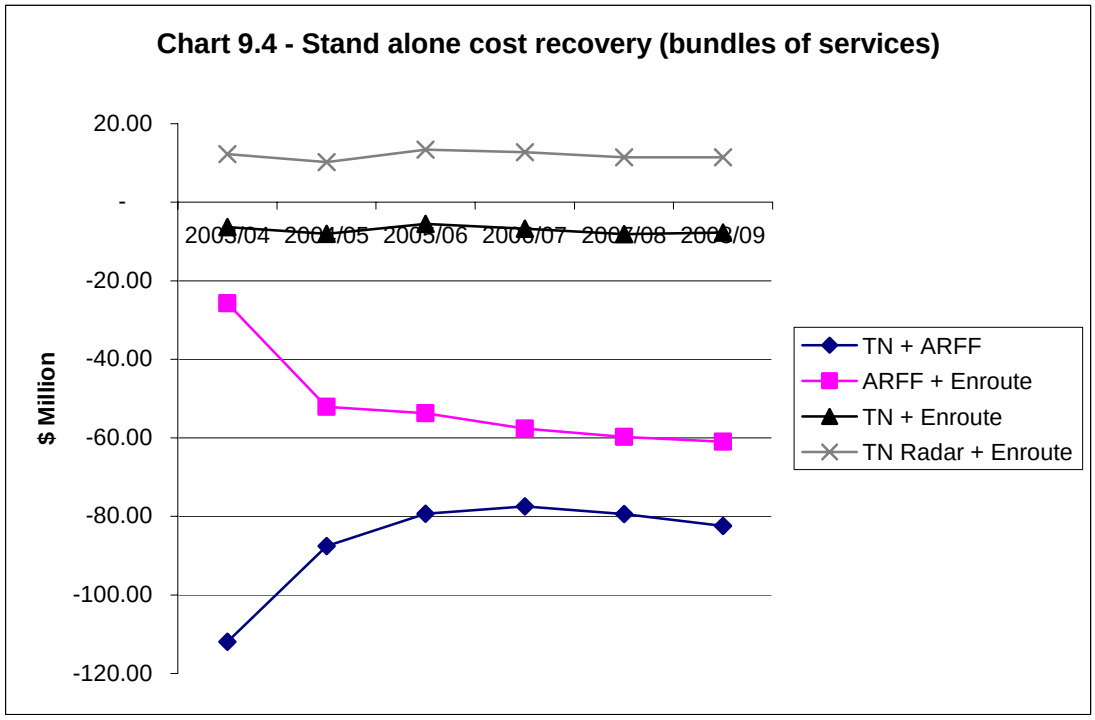


Chart 9.4 shows that the bundle of services which includes both TN radar and en route services is expected to recover in excess of the combined stand-alone cost for the duration of Airservices' pricing proposal.

Therefore, as TN and ARFF services at regional and GA locations are expected to recover less than incremental costs and the bundle of en route and TN services at radar locations is expected to recover in excess of stand-alone costs, there appears to be a degree of cross-subsidisation of TN and ARFF services at regional and GA locations by en route and TN services at radar locations.

This result of a cross-subsidy is based on the assumption that demand for services at regional and GA locations is independent of demand for services at other locations. However, from an efficiency perspective, such a cross-subsidy would only be of immediate concern if either:

- competition is going to be introduced for the provision of certain services currently provided only by Airservices in the next five years, in which case the cross-subsidy might lead to inefficient entry

- the level of the cross-subsidy is such that regional and GA airports are being kept open when the value of these airports to their users is less than the cost of these airports.

The ACCC has not been provided with any evidence to suggest that either of these conditions applies. Therefore, while the existence of the cross-subsidy may be a cause for concern on equity grounds, it does not appear to be a concern on efficiency grounds as long as prices exceed marginal costs. In addition, the ACCC has been provided with some evidence to suggest that the services at regional and GA airports and at other airports are substitutes in demand. As Faulhaber notes, in this situation, claims of cross-subsidy need to be treated with caution.

The ACCC's primary focus therefore, in relation to the structure of Airservices' charging, is how Airservices' prices relate to marginal cost. In this respect, economically efficient prices for services may involve some services being priced below incremental cost if relatively higher prices would lead to inefficient substitution to other, less preferred services.

The ACCC notes the existence of cross subsidies in Airservices' proposed pricing structure and it will monitor this situation, particularly if there is a likelihood of competition being introduced to certain services of Airservices. However, the present existence of cross-subsidy does not necessarily imply economic inefficiency.

(c) The basis of Airservices' charging

As noted above, the ACCC is concerned to examine how Airservices' prices relate to marginal cost. In this respect, concerns were raised in a number of submissions about Airservices' approach to pricing, in terms of the unit of measurement applied as the **basis** for imposing charges in respect of each of its three services: ARFF, TN and en route.

The issue of the appropriate basis for ARFF pricing is a major concern for a number of interested parties which operate or have an interest in Ayers Rock, Townsville or Maroochydore airports, where there are new or proposed ARFF services. Airservices charges for its ARFF services on the basis of MTOW of aircraft, with a minimum threshold of 2.5 tonnes.

This issue also arose in Airservices' price notification of April 2004 for the introduction of a new ARFF service at Ayers Rock airport. While the ACCC did not oppose Airservices' price notification, this decision was a temporary one, pending long-term pricing arrangements being established. In its decision, the ACCC considered that legitimate concerns had been raised in the consultation process about the basis of charging for ARFF services. In particular, the ACCC expressed concerns about both the basis of charging and whether the threshold limit (2.5 tonnes) is achieving its intended purpose, which it understood to be to distinguish between GA aircraft and commercial regular public transport aircraft.

However, a detailed examination of this issue was beyond the scope of the April 2004 price notification and the ACCC encouraged Airservices to examine this issue as part of the development of its long-term pricing proposal. The ACCC notes that Airservices has resolved to defer this issue until after its long-term pricing proposal is in place.

The ACCC considers that the basis for charging for ARFF services should be reconsidered in light of the following issues:

- the introduction of a new ARFF service considered in its entirety
- the introduction of a new ARFF service to particular distinguishable user groups at a particular airport
- the level of ARFF service provided, once a service has been established at a particular airport.

On the first issue, the establishment criteria for establishing an ARFF service is the number of passengers passing through an airport.[44] The establishment criteria specify that an ARFF service must be provided within twelve months:

- at any domestic aerodrome from or to which an international passenger air service operates
- at any domestic aerodrome through which more than 350,000 RPT passengers passed through during the most recent financial year.

In addition, an ARFF service may be provided at an aerodrome where the total annual number of passengers on air transport is less than 350 000. This service must be at a minimum of category two where an aircraft of less than 30 seats operates as air transport and at a minimum of category four where an aircraft with 30 passenger seats or greater operates as air transport.

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[44] CASR r. 139.755 and Division 139.H.3 generally.

It is therefore apparent that the cost drivers to the establishment of a new ARFF service are numbers of RPT passengers or international passenger air traffic. While there may be a correlation between MTOW and RPT passenger numbers, this does not appear to be the case at the lower end of the range for MTOW and it does not appear that the threshold limit of 2.5 tonnes adequately addresses this issue. For example, the ACCC understands that RFDS aircraft weigh in excess of the threshold limit, but carry no RPT passengers.

On the second issue, it appears to the ACCC that the cost of providing a new ARFF service is primarily a common cost for the provision of ARFF services to different user groups at an airport. Once established, there is no clear (causal) basis for apportioning the costs of the ARFF service between users. In such a case, Ramsey pricing principles suggest allocating such costs in inverse proportion to the elasticity of demand of users, to maximise economic efficiency.

It appears that there may be groups of users at the three airports mentioned above which are distinguishable on the basis of elasticity of demand and it may be efficient in such circumstances to price discriminate between such user groups to collect a greater proportion of the cost of providing an ARFF service to the group of users that is least responsive to price changes.

On the third issue, within certain ranges of activity related to CASR regulations, it appears to the ACCC that the marginal cost of provision of an ARFF service would be close to, if not zero.

It appears to the ACCC that Airservices' existing basis of charging for ARFF services (on the basis of MTOW, with a minimum threshold of 2.5 tonnes) is not likely to be efficient because the price charged to smaller operators at those airports where an ARFF service is in existence or will be in existence, does not appear to be related to the impact of these operators on Airservices' costs. Moreover, the introduction of new ARFF services using the existing basis for charging is likely to have large impacts on particular user groups. The ACCC therefore considers that Airservices should address this issue of its charging structure before introducing long-term pricing arrangements.

The basis of TN charging was also questioned in submissions, with the suggestion made that the current basis of charging, tonnes landed, results in a cross-subsidy to the flying training schools, which pay on the basis of the number of landings and do not include 'touch and go' landings. Airservices has recognised that the issue of movement charges at GA locations is something which it will continue to explore; however, it has not provided any supporting information in its draft pricing proposal on how this will be conducted, including the identification of the cost drivers it faces in providing TN services. This is an issue which the ACCC considers Airservices should address; however it does not appear to be as critical an issue as the pricing of ARFF services.

Concerns have also been expressed in relation to the basis of en route charging, with arguments made that the cost of providing the service is independent of the weight of the aircraft and that the current charging structure results in international operators being burdened with a disproportionate share of the costs. As with the issue of the basis of TN charges, the ACCC considers that Airservices should address this issue before the next pricing period is entered into.

9.1.15 Conclusion

The ACCC welcomes the greater level of transparency Airservices has provided users regarding the costs underlying its current pricing proposal. However, the ACCC does have concerns with the structure of Airservices' prices. The key conclusions are outlined below.

(a) Cost allocation

The ACCC considers that Airservices' approach to allocating its common costs in a way which allocates a larger proportion of these costs to larger airports, appears in several respects to be broadly consistent with the inverse elasticity of demand method of cost allocation and, as such, is a reasonably efficient, as well as transparent approach.

(b) Application of the 'basin concept' in setting prices for TN services

The ACCC does not believe that an adequate justification of the proposed application of the basin concept in TN pricing has been advanced. While the application of the basin concept in setting TN prices at basin airports makes an adjustment to take into account claimed interdependencies and shared resources between airports in basin areas, a fuller development of this adjustment is desirable. The ACCC considers that the costs of shared resources in a capital city basin should be explicitly allocated between airports in the same transparent manner as for other common costs.

However, the ACCC sees potential merit in incorporating demand-side interdependencies (such as movement congestion in a common basin airspace) and would encourage Airservices to develop the estimation of the appropriate associated adjustments to charges. This would enable an adequate basis for the basin pricing concept to be assessed.

(c) Timing of price increases

The ACCC acknowledges that Airservices has responded to the feedback received from regional and GA operators by phasing in its proposed price increases over the period of the pricing proposal.

It is arguable that Airservices could have gone further and proposed uniform price increases (of 11.36 per cent) in each year of the proposal. However, in the context of estimated costs being significantly higher than the proposed prices, Airservices' approach of moving to a closer alignment of prices with costs in the first period by increasing prices by the maximum specified in the ministerial direction, appears to the ACCC to be reasonable.

(d) Prices across services and user groups

The ACCC does not consider that Airservices should revert to a network pricing approach, because location-specific pricing can encourage productive efficiency at locations and has beneficial equity implications between users of Airservices' services.

It appears, on the information made available to the ACCC, that the price increases in Airservices' proposal do not eliminate a cross-subsidy from the en route service and TN services at radar airports to regional and GA TN and ARFF services. However, this result must be treated with some caution, to the extent that there is substitutability in demand between the services at regional and GA locations and other airports. The ACCC notes the apparent cross-subsidy and will monitor this, particularly if there is a likelihood of contestability being introduced to Airservices' services.

The ACCC is particularly concerned that Airservices has not reassessed the basis for charging for its ARFF services and considers that the current basis for charging is not likely to lead to efficient outcomes. The ACCC considers that Airservices should address this issue before introducing long-term pricing arrangements, and particularly calls for any further views from interested parties on the appropriate basis for charging for ARFF services.

10 Impact on Users

10.1 Introduction

The requirement to consider the impact on users is in part derived from the object of prices surveillance and the considerations set out in section 95G(7) of the Act, which requires that the ACCC have regard to the need to maintain investment and employment.

Supporting this, the ACCC's 'Draft statement of regulatory approach to price notifications' states that information from users is important in understanding the issues and indicates that the ACCC will consult with users as part of the assessment process.

In its 2003 decision, the ACCC formed the view that price increases for TN services in Airservices' pricing proposal would be more significant for domestic users than international users. Further, while the ACCC expressed concern about the scope for price increases to influence demand for services, it considered that the consequential impact of small increases in prices would be relatively small, given their very small share of total operating costs for most, although not all, users.[45] As such, the ACCC was more concerned about the degree to which Airservices' prices reflected the appropriate costs and encouraged efficient use of facilities.

The ACCC's approach to assessing the impact on users of Airservices' proposed prices in 2002 and 2003 involved an assessment of the impact of prices on both direct and end users (notably operators and passengers/customers), and in 2002 a further distinction was made between international and domestic airlines.

The ACCC intends to apply a similar approach in assessing the impact on users of price increases in Airservices' current proposal.

10.2 Airservices' position

Airservices developed a long-term pricing proposal in consultation with the ISC after the ACCC objected to its temporary price notification in 2003.

After recognising that regional and GA stakeholders were not adequately represented in the ISC, Airservices held a more extensive consultation process with regional and GA operators.

The prime concern expressed in these responses was that a transition to full location-specific pricing based on costs fully allocated using an ABC approach was untenable and it was claimed would result in business closures and dysfunctional behaviour at smaller locations.

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[45] Airservices' charges are relatively more significant for small users such as GA and regional operators.

Airservices submits that its current pricing proposal is a viable pricing strategy that balances the parameters considered by the ISC with the key concerns expressed by regional and GA operators.

Airservices considers the impact of price increases on domestic user groups in its proposal. In particular, Airservices considers the effect of increases in prices:

- on the ticket prices for large aircraft movements between the top 25 revenue city pairs
- for TN and ARFF services at airports on ticket prices for small aircraft (less than 2.5 tonnes)
- on the hourly costs of training at GA airports.

Airservices considers the impact of price increases on large aircraft movements between the top 25 revenue city pairs in 2003–04 and 2004–05 as a proportion of the lowest priced internet fare. Airservices notes that the largest increase, as a percentage of a low internet ticket price, as an average on the top 25 routes is estimated at $0.69 or 1.1 per cent of the airfare, for a 747-400 passenger jet.

Airservices estimates that, for international routes, the largest increase to passengers' airfares as a proportion of the lowest internet fare is for a 747-400 passenger jet on the Auckland-Brisbane pair at $0.96, or 0.6 per cent. Based on this analysis, Airservices submits that the impact of the proposed price changes on major routes is not expected to be material.

Airservices estimates the impact of the change in prices for TN and ARFF services on ticket prices for aircraft less than 2.5 tonnes for the periods between 2003–04 and 2004–05, using an estimate of 1.55 passengers per tonne. Airservices submits that the estimated impact of the proposed increases in TN and ARFF prices on ticket prices ranges from $0.49 to $1.89 for existing services.

However, Airservices notes that the introduction of new ARFF services at Maroochydore and Townsville is more significant, with increases in fares expected to be in the order of $10.67 and $6.46 per ticket respectively. Airservices further submits that, while these price increases are large, the combined proposed charges are in line with comparable regional airports.

Airservices also considers the impact of price increases in its proposal on GA training for a Cessna 172 over the five-year period. Airservices' analysis suggests that the price changes in its proposal would result in increases in costs of around $1 per hour, for each year of its pricing proposal. Airservices submits that the change in Airservices' prices would lead to an increased cost of $5 per hour at the end of the five-year period, which equates to a cumulative increase over the five-year period of 2.56 per cent (based on hourly training fees of $195).

10.3 Views of interested parties

The ACCC's issues paper sought views on the impact of the proposed price increases on the demand for air travel, airline scheduling decisions, providers of other aviation services, airfares and regional and GA activity.

In response to the ACCC's issues paper, some interested parties commented on the ability of different operators to pass on price increases to customers.

Some respondents suggested that users at GA and regional airports will have difficulty passing on price increases, and are less able to do so in comparison to users operating RPT services. Further, some submissions argued that RPT operators who were also full service carriers would be better able to pass on price increases to customers.

In particular, Aeromil considers that the industry at Maroochydore does not have the capacity to absorb the price increases nor the loss of business which will follow the introduction of ARFF service charges. Neither does it consider that it has the ability to pass the price increases onto customers. It submits that it is only the major airlines carrying passengers that can pass on the charge on a revenue seat basis.

Aeromil further submitted that in the past there has been no requirement for ARFF services to oversee the arrival and departure of its 19 seat Metro III passenger flights, which operate outside the hours which the major carriers operate. Therefore, an extra two shifts per day are required to allow services to be operational when its Metro III flights depart and arrive, resulting in an unnecessary increase in its costs. However, since making its submission, Aeromil has informed the ACCC that the major carriers have expanded their schedules at Maroochydore airport and now operate in the early evening, overlapping with the ARFF shift required for its aircraft's arrival.

The Jandakot Airport CC submits that, with external factors beyond its control putting pressure on petroleum prices, GA looks to control all costs as tightly as possible. RPT is more able to pass on costs to their customers with fuel surcharges etc. This is not so easy to do in the 'non oligarchic, competitive GA industry'.

RVAC submitted that it is difficult for flying schools at Moorabbin airport to pass on Airservices' price increases because they face fierce competition from the 10 other flying schools present, and from flying schools operating out of non-controlled airfields that don't face these cost increases. Further to this the RVAC stated that flying schools at GA airports cannot easily relocate to non-controlled airfields, as these airfields are privately owned with their own flying schools already operating from them. In addition, it stated that flying schools own their own infrastructure on leased land and cannot find a ready market to sell.

RVAC submitted that, of the 300 aircraft operating at Moorabin airport, only one of these aircraft (a business jet) would not be able to relocate to a non-controlled airport.

Virgin Blue submits that 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 high 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 (e.g. business class seating and business clubs at airports).

Virgin Blue contends that the financial burden of increased TN and ARFF charges is likely to be greater for Virgin Blue than full service carries. 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.

Further, Virgin Blue argues that when airlines are forced to pass on increased charges for air navigation services, the resultant fall in demand will be highest amongst 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.

Some interested parties were particularly concerned that Airservices' pricing proposal would lead to different prices for services provided in similar locations, and that such differential pricing would affect competitive outcomes, as it would result in users moving to the lower priced airport.

Linfox contends that Essendon airport and Melbourne airport compete for corporate jet activity, and that the prices in Airservices' proposal will lead to a severe difference in pricing for Essendon airport and will likely strengthen Melbourne airport's powerful market position. Linfox submits that the price for TN services in the final year of Airservices' pricing proposal for a 40-tonne jet flying into Melbourne airport will be $202.40, whereas the price at Essendon airport for the same service will be $507.60. It states that this is a 250 per cent difference, which will result in more jet air traffic moving to Melbourne airport at the expense of Essendon airport.

Adelaide airport noted that overpricing in the location-specific pricing regime could lead to the relocation of GA and flying training to heavy aircraft airspace which would compromise capacities and growth potential for the broader economic benefit of the states and territories.

Rockhampton CC submits that the increases in Airservices' charges and its discriminatory pricing methods have the potential to reduce the appeal of Central Queensland as a tourism destination by distorting ticket prices in favour of other destinations.

Further, some interested parties contended that the increases in Airservices' charges would lead to movement away from Airservices' airports to non-controlled airports.

Gold Coast airport submits that there will be reduced operations at regional airports that are subject to the increased charges and increased use of aerodromes that do not provide ATS or ARFF. Gold Coast airport submits that the natural inclination to avoid any use of air traffic control services will impact on the possible safety of operations, and thus increase risk to passengers and the general public.

DPIWA submits that there is unanimous agreement from stakeholders that demand for services would significantly decrease if the new pricing proposal is introduced.

However, DPIWA notes that many businesses at Jandakot airport have long-term lease agreements with the airport owners that would preclude them from relocating, and also that it may not be possible for those businesses without restrictive leases to relocate due to the nature of their businesses.

RFDS and RFDSQ submit that Airservices' prices provide an incentive for users to relocate to airfields that are not subject to any Airservices' charges (if the particular owner or business can do so) as has already happened to an extent with airfield privatisation.

RAAA contends that the impact of Airservices' draft price notification will be a decrease in the use of towered regional and GAAP airports which will flow through to an increase in airfares. Both of these effects will lessen demand for air travel and have adverse effects on aviation associated businesses and their employment levels.

Mackay PA submits that the differences in prices for similar services between locations will influence the decision of airlines to place additional fleet capacity. Mackay PA questions why airlines fly extra daily services to Mackay airport when it is going to cost them $592 905 more a year than operating a comparable Brisbane or Melbourne to Sydney service.

In particular, some submissions considered that the significant increases in prices at airports with new ARFF services would have a negative impact on operators' businesses, and would lead to businesses relocating their operations to other airports.

SFC submits that the price differential between Rockhampton and Brisbane airports could result in a saving of $285 000 if SFC moved its operations to Brisbane airport.

The Mackay PA submits that Jetstar has advised it that instead of increasing its four times weekly direct Sydney service to daily, it will place the extra three services into Prosperine airport (120 km away) because it doesn't have to pay tower or ARFF charges at that airport. The Mackay PA submits that Jetstar will be $20 a passenger better off by doing so.

Sunshine Express contends that the recently released charges for the introduction of the fire fighting service to the Sunshine Coast will force Sunshine Express' directors to look at the option of relocating Sunshine Express' business to Brisbane airport and cease all flights into and out of the Sunshine Coast and the Hervey Bay region.

In its submission to Airservices' initial consultation process, Cairns PA submitted that pricing tower services and fire fighting services through location-specific pricing could have a dramatic impact in low volume destinations to the extent of influencing the local tourism market, but also having a significant impact on the Australian tourism market.

Cairns PA stated, by way of example, that Cairns operates with 40 per cent of its domestic network used by international travellers, which it states would not be unusual within the regional destinations of Australia. It submitted that if Airservices' pricing to regional networks impacts the sustainability of air services into regional ports, it will not be solely the impact of tourism on that destination but also tourism in the overall Australian market that will be impacted.

In addition, a number of submissions expressed concern about the effect the price changes would have on the operations of flying schools, given that the price increases in Airservices' pricing proposal were amongst a number of price increases that flying schools faced at this time.

Further, Adelaide airport and Maroochy SC highlighted the possibility of flying schools moving overseas in response to the price increases.

China Southern submit that the increase in fees needs to be considered in the context of other price increases the GA business is facing in the time frame. In addition to the price increases in Airservices' pricing proposal, China Southern faces the following increases in costs:

- increases in CASA fees for flying operations inspectors and exam fees
- likely increases in fees at Jandakot airport to reflect increases in costs
- costs of compliance with new CASA training regulations (CASR Part 61 flight crew licenses and part 141 flight training operators rules)
- significant increases in fuel costs.

The Jandakot Airport CC submits that for the large GA Industry, training hundreds of students thousands of hours a year, the hikes represent a significant cost burden with an annual impost per year of up to $100 000 per year for one large school training overseas pilots. At this magnitude, it expects to see some downturn.

Maroochy SC submits that the price increases in Airservices' proposal will have a major impact on the viability of non passenger flights such as SFC, an organisation that trains Singapore Airlines pilots only. Singapore Airlines may relocate its business offshore as a result of the ARFF charge.

The Metropolitan Ambulance Service, the International Society of Aeromedical Services (ISAS), and branches of the Royal Flying Doctor Service all expressed concern about the effect of the price increases in Airservices' pricing proposal on their costs. Interested parties also highlighted the difficulty in recouping cost increases from end users without placing a financial burden on them.

The ISAS submits that any sudden, unexpected or substantial increase in fees is of concern. It submits that many aeromedical operations rely on government fund raising and transport fees to support costly operations, and that fee increases of this magnitude cannot simply be passed on to the users of its services without placing a financial burden on them.

The RFDSW submits that if the government is unable to increase funding to meet costs at a sufficient level, it will need to consider downgrading the level of service. This could lead to the closure of bases, diverting less critical patients to Perth airport, where there are no medical support facilities, limiting the number of cases it responds to, or a lengthening of response times.

10.4 ACCC views

The ACCC separates consideration of the effect of the proposed prices in Airservices' proposal into the effect on the **direct users** of Airservices' services (such as airlines, flying schools, and operators of aeromedical services), and the effect on the **indirect users** of Airservices' services (such as travellers, flying school students, and users of

aeromedical services). This follows the approach taken by the ACCC in assessment of Airservices' past price notifications.

10.1.1 Impact on direct users

(a) Impact on major airlines

In the case of airlines, an increase in prices charged by Airservices presents them with options between:

- absorbing the price increase
- passing on the entire increase to consumers, affecting the price of the airfare.

An airline's ability to absorb cost increases depends on the market environment in which it is operating: airlines are more likely to have to pass on cost increases if they operate in a competitive market.

Virgin Blue submits that full service carriers are better able to pass on cost increases arising from Airservices' proposal because they have a greater proportion of price inelastic customers.

In the ACCC's view, the extent to which the cost increases arising from increases in Airservices' charges will be passed on by airlines to their customers depends on the competitiveness of the various 'sub-markets'; if these 'markets' are competitive, the cost increases will tend to be passed on. However, in the case of 'full-service carriers', Airservices' charges represent a cost that is joint across different fare classes it operates. Such a carrier (especially in the context of frequent flyer or other loyalty programs or clubs) may pass on a greater share of the joint cost to the less elastic (primarily business class) travellers.

Notwithstanding the likely relative impacts on different 'sub-markets' within domestic and international air travel, given that price increases for most air services will be small, the ACCC considers that the price increases in Airservices' proposal will not have a major adverse impact upon international and domestic RPT operators or their passengers.

(b) Operators at regional and GA locations

The response of regional and GA operators to Airservices' initial pricing proposal has resulted in significant changes to Airservices' proposed price path:

- Airservices' new approach to the allocation of distributed costs results in a greater allocation of 'distributed costs' to major metropolitan airports.
- The application of the basin concept in setting prices for TN services at airports in basin locations results in a greater increase in prices at some major metropolitan airports, and a smaller increase in prices at some secondary locations.
- Airservices' has placed an upper limit on annual price increases of 16.8 per cent in year one and 10 per cent in years two to five of its pricing proposal.

However, submissions in response to the current pricing proposal contend that price increases will have a negative impact on regional and GA operators, and result in some of these operators moving to non-controlled airfields. Alternatively, some respondents stated that there would be a move from regional and GA locations to capital city airports that are within close proximity.

The ACCC notes that where airports in similar geographic locations compete for the same users, price differentials will impact on competition between these locations by strengthening the incentive for users to move from the higher priced to the lower priced location. Of course, other factors, such as quality of the services, the location and accessibility of the airport site, will also shape operators' site decisions.

The increasing difference in prices between locations in Airservices' pricing proposal (particularly the differentials between primary and secondary airports in the same basin areas) are a result of location-specific pricing and the increase in and subsequent removal of price caps for TN services at GA and regional airports.

The ACCC considers that such differentials are appropriate where such price differentials refect economy of scale effects which make it cheaper to provide a service at a major airport, and relevant externality effects (such as the reduction in efficiency from congestion which may result from GA operating out of major airports) are properly taken into account in the pricing. To impose common prices at such locations may distort efficient competitive outcomes in favour of the secondary location airports.

However, the ACCC considers that while differential pricing for the same services at airports in similar locations can create an incentive for users to move between airports, the decision a user faces in relocating between airports depends not only on the differences in Airservices' prices, but on a range of other factors, such as long-term leases at the higher priced airport, different terminal access charges, terminal availability, and any demand management measures exercised by the lower priced airport owner.

Airservices' analysis suggests that price increases in its proposal will result in increases in ticket prices between $0.49 and $1.89 for existing regional services.

(c) Providers of aeromedical services

Providers of aeromedical services submitted that they could either recover increased costs by passing on the price increases to their members, or by seeking increased funding from the government.

Further, the Metropolitan Ambulance Service submitted that an option would be to relocate its operations from Essendon airport to Melbourne airport, where TN charges are cheaper. However, it stated that although the increase in TN costs could be partially defrayed by such a move, there are a number of other financial and non-financial factors, which it stated could be prohibitive.

(d) Flying school operators

Flying schools in Australia appear to operate in a competitive market and it is likely that they will fully pass on Airservices' price increases to their students. This may have the effect of a contraction in scale or the number of flying schools operating at controlled airports.

The extent to which flying schools and/or students move to non-controlled airports or overseas depends on a number of factors, not just the relative prices for Airservices' services. In particular, schools operating at non-controlled airports are, in general, less attractive to student clients. Airservices' analysis of the impact of the price increases on flying schools suggests that the effect will be small and is unlikely to have a significant effect on flying schools. However, Airservices' analysis is based on a Cessna 172, which the ACCC understands would not be subject to ARFF charges, because its weight falls below the threshold limit. SFC submitted that a Lear 45 with two students would be charged $110 per student for a landing at Maroochydore airport.

(e) Impact of price increases on operators at airports with new ARFF services

Submissions have raised the concern that the introduction of new ARFF services at Ayers Rock, Townsville and particularly Maroochydore airports will have a significant impact on the businesses operating out of these locations, and may lead to relocation of these businesses to other airports.

Whereas Airservices has placed an upper limit on its annual price increases of 16.8 per cent in year one and 10 per cent in years two to five, this does not apply to the introduction of new ARFF services. In the case of Maroochydore, for example, a new charge of $15.29 per landed tonne is proposed to be introduced immediately, increasing to $22.39 by year five.

10.1.2 Impact on indirect users

The impact that the price increases in Airservices' proposal will have on indirect users depends on the market structure in which the services operate, with more competitive markets likely to result in pass-through of increased costs to users, and on the elasticity of demand of such users. In the long-run, higher prices may lead to some contraction in the operations, scale or location of a number of operators.

Airservices' analysis suggests that the impact of its price increases on fares for major domestic and international routes is not material. Airservices has assumed a full pass-through of costs to these fares.

The affect on demand for flights will differ across different routes, reflecting different demand elasticities for the services. For example, demand on routes which have a high proportion of tourists is likely to be more sensitive to price increases than those routes which have a higher proportion of business travel. In addition, demand elasticities will vary with the levels of airfares; the lower the fare, generally the greater the sensitivity to price changes.

It appears that the likely effect of the proposed price increases will not be material for passengers on the major domestic and international routes, although the effect on passengers of 'low cost' carriers is likely to be relatively larger.

Given the competitive nature of the market for flying lessons and the relatively high cost of flying lessons, it appears unlikely that Airservices' proposed price increases will have a significant effect on the demand for flying lessons, except in the case of larger aircraft subject to ARFF charges, where it appears that the impact of introducing ARFF charges at Maroochydore airport, may have a substantial effect.

The effect of the increases in Airservices' prices on users of aeromedical services is unclear, because this will depend on the extent to which these users receive additional government funding to cover the increase in costs.

10.1.3 Conclusion

The ACCC notes that although Airservices' pricing proposal is not likely to have a large impact on the costs of RPT operators, and consequently on airfares - the prices in Airservices' proposal will impact particularly on users of services at airports that have new ARFF services.

11 Conclusion and preliminary view

The ACCC's discretion under the provisions of Part VIIA of the Act is essentially limited to objecting or not objecting to price notifications put before it.[46]

The ACCC accepts the overall revenue amounts underlying Airservices' proposed long-term pricing arrangements. However, it has an immediate concern with the basis of ARFF charges. The ACCC considers that the current basis for imposing charges, on the basis of MTOW with a threshold of 2.5 tonnes, is not likely to be efficient and the introduction of new ARFF services using the existing basis of charging is likely to have large impacts on particular user groups. The ACCC therefore considers that Airservices should address this issue of its charging structure before introducing long-term pricing arrangements.

The ACCC's preliminary view is to object to Airservices' price increases proposed for ARFF and to not object to the price increases proposed for TN and en route.

[46] Under section 95Z(6)(c), the ACCC may also suggest lower prices that it considers should apply. However, it has no power to impose any such prices.

Appendix A: List of submissions

The ACCC received submissions from the following parties regarding Airservices' draft notification:

- Adelaide airport
- Aeromil (Australia) Pty Limited (Aeromil)
- Airport Development Group Pty Ltd (ADG)
- Archerfield Airport Corporation (Archerfield airport)
- Board of Airline Representatives of Australia Inc (BARA)
- British Airways (BA)
- Cairns Port Authority (Cairns PA)
- Canberra International Airport Pty Ltd (Canberra airport)
- Cathay Pacific Airways Limited (Cathay Pacific)
- China Southern West Australian Flying College Pty Ltd (China Southern)
- Department for Planning and Infrastructure Government of Western Australia (DPIWA)
- Department of Transport and Urban Planning (DTUPSA)
- Emirates
- General Aviation Maintenance Pty Ltd (GAM)
- Gold Coast Airport Limited (Gold Coast airport)
- Great Barrier Reef airport
- International Air Transport Association (IATA)
- International Society of Aeromedical Services (ISAS)
- Jandakot Airport Chamber of Commerce (Jandakot Airport CC)
- Jandakot Airport Holdings Pty Ltd (Jandakot airport)
- Linfox Airports Pty Ltd (Linfox)
- Mackay Port Authority (Mackay PA)
- Maroochy Shire Council (Maroochy SC)

- Metropolitan Ambulance Service
- NA Sanbrook
- Qantas Airways Limited (Qantas)
- Regional Aviation Association of Australia (RAAA)
- Rockhampton City Council (Rockhampton CC)
- Royal Flying Doctor Service of Australia (Central Operations) (RFDS)
- Royal Flying Doctor Service of Australia (Queensland Section) (RFDSQ)
- Royal Flying Doctor Service of Australia (Western Operations) (RFDSW)
- Royal Victorian Aero Club (RVAC)
- Singapore Airlines
- Singapore Flying College (SFC)
- Singapore Flying College (Jandakot) (SFCJ)
- Sunshine Express Airlines (Sunshine Express)
- Sydney Metropolitan Airport Business Council Inc (SMABC)
- Victorian Regional Air Charter Pty Ltd (VRAC)
- Virgin Blue

The submissions are available on the ACCC's website at www.accc.gov.au.