



Australian
Competition &
Consumer
Commission

Airservices Australia draft price notification

Preliminary view

July 2011



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Glossary

ACCC	Australian Competition and Consumer Commission
AER	Australia Energy Regulator
Airservices	Airservices Australia
ANSP	Air Navigation Service Providers
AOPA	Aircraft Owners and Pilots Association
ARFF	aviation rescue and fire fighting
ARTN	Australian Regional Tourism Network
AS Act	<i>Air Services Act 1995</i>
ATC	Air Traffic Control(ler)
BARA	Board of Airline Representatives of Australia Inc.
CAPM	Capital Asset Pricing Model
CASA	Civil Aviation Safety Authority
CCA	<i>Competition and Consumer Act 2010</i>
CPI	consumer price index
en route	en route navigation
FIR	Flight Information Region
GA	General Aviation
GAAP	General Aviation Aerodrome Procedures
KPIs	Key Performance Indicators
IATA	International Air Transport Association
ICAO	International Civil Aviation Organisation
LTPA	long-term pricing agreement
MRP	market risk premium
MTOW	maximum take-off weight
PCC	Pricing Consultative Committee
PS Act	<i>Prices Surveillance Act 1983</i>
Qantas Group	Qantas, Jetstar and Qantas Link
RAAA	Regional Aviation Association of Australia
TAS	technology and asset services
TN	terminal navigation
vanilla WACC	The weighted average of the post-tax return on equity and the pre-tax cost of debt
VAA	Virgin Australia Group of Airlines
WACC	weighted average cost of capital

Executive Summary

The ACCC's preliminary view

The Australian Competition and Consumer Commission's (ACCC's) preliminary view is to **object** to Airservices Australia's (Airservices') proposed price increases for TN and ARFF services. Charges for en route services were proposed to remain unchanged.

The ACCC is concerned that Airservices has not undertaken adequate consultation to ensure that its proposed capital expenditure program is prudent and efficient. Further, the ACCC considers that there is scope for Airservices to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets. The ACCC also considers that the methodology applied by Airservices in estimating the nominal risk-free rate and cost of debt margin has resulted in a proposed rate of return that is currently too high. This means that Airservices would over-recover its required revenue based on its proposed prices.

The ACCC considers that if Airservices can address these matters prior to submitting its formal price notification, then the ACCC would be minded to not object.

In March 2011, Airservices Australia (Airservices) submitted a draft price notification to the Australian Competition and Consumer Commission (ACCC) in accordance with the ACCC's informal pre-lodgement process for assessing price notifications under Part VIIA of the *Competition and Consumer Act 2010* (CCA).

Airservices' draft price notification covers a five-year period (2011-12 to 2015-16). In its draft price notification, Airservices proposed increases to the charges for its terminal navigation (TN) and aviation rescue and fire fighting (ARFF) services. Charges for en route navigation (en route) services remain unchanged. Charges for these services are levied on airlines and other operators of aircraft landing at Airservices' controlled airports in Australia and flying in airspace that is controlled by Airservices. Airservices also proposed some changes to its pricing methodology and structure. Airservices' current and proposed prices are provided in appendix A.

Airservices' proposed price increases reflect the effect of a large increase in capital expenditure to the sum of \$958 million over the five-year period, which will drive up unit costs. Importantly, Airservices expects that this increase in unit costs will overwhelm the effect of continued growth in demand, which would be expected to drive down unit costs.

In April 2011, the ACCC released an issues paper seeking submissions from interested parties on the proposed price increases embodied within Airservices' draft price notification. The ACCC received a total of 14 submissions. All of these submissions have been considered by the ACCC in forming its preliminary view.

In undertaking its assessment of Airservices' draft price notification, the ACCC has identified a number of key issues that it considers that Airservices needs to address prior to submitting its formal price notification.

Airservices needs to improve its level of consultation with stakeholders to ensure prudence and efficiency of capital expenditure

The ACCC is concerned that Airservices has not undertaken adequate consultation with stakeholders to ensure that its capital expenditure program is being undertaken prudently and efficiently. Indeed, a number of stakeholders have expressed concerns relating to the level of information provided by Airservices, the effectiveness of the consultation, and that stakeholders' views have not been taken into account or have not been addressed. For example, stakeholders have raised concerns in relation to the ATM Future System project included in Airservices' proposed capital expenditure.

The ACCC considers that there is scope for Airservices to improve its consultation processes to allow stakeholders to provide more informed input on the benefits and costs of specific projects. Stakeholders are in a strong position to assess the value of capital investment proposals by, for example, providing feedback on activity forecasts and service-quality preferences.

Airservices needs to improve its drivers of efficiency

The ACCC considers that, although Airservices has made some progress in incorporating efficiency targets and benchmarks, there is still scope for it to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets.

Airservices needs to review its methodology for estimating its rate of return on capital

The ACCC does not accept Airservices' proposed rate of return on capital as appropriate for this assessment on the basis that it does not accept the methodology applied by Airservices in estimating the nominal risk-free rate and cost of debt margin. Any adjustment to the rate of return on capital needs to be reflected by an associated adjustment to the required revenue and prices for users.

The ACCC is now seeking comments on this preliminary view

To facilitate an informed, transparent and robust consultation process, the ACCC prefers that all submissions are publicly available. Accordingly, submissions will be treated as public documents and posted on the ACCC's website, unless prior arrangements are made with the ACCC to treat the submission, or portions of it, as confidential.

The ACCC will accept submissions by email (preferred) or by post. If submissions are provided in PDF format, parties are asked to also provide a copy in Microsoft Word format.

Submissions should be provided to the ACCC by COB on Monday 1 August 2011.

Submissions by email are preferred. They can be sent to: airport.group@acc.gov.au.

Submissions can also be mailed to:

Mr Anthony Wing
General Manager—Transport and General Prices Oversight Branch
Australian Competition and Consumer Commission
GPO Box 520
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If you have any questions about the process, or about making a submission to the ACCC, please contact Renée Coles on 03 9290 6921, or send an email to: airport.group@acc.gov.au.

Following this consultation process, the ACCC will consider submissions received before inviting Airservices to submit its formal price notification. Following receipt of a formal price notification, the ACCC has 21 days in which to release a final decision. The ACCC expects to release a final decision in September 2011.

Part A: Introduction

On 7 March 2011, the Australian Competition and Consumer Commission (ACCC) received a draft price notification from Airservices Australia (Airservices) covering all of its regulated services: terminal navigation (TN), en route navigation (en route), and aviation rescue and fire-fighting (ARFF) services. The draft price notification covers a five-year period, 2011-12 to 2015-16, and includes increases to its charges for TN and ARFF services, while charges for en route services remain unchanged.

The ACCC released an issues paper on Airservices' draft price notification on 7 April 2011, calling for submissions from interested parties by 10 May 2011. The ACCC received a total of 14 submissions from industry and other stakeholders. A list of the submissions is provided in appendix B.

Airservices' draft price notification and supporting documentation as well as the ACCC's issues paper and submissions received are available on the ACCC's website at: www.accc.gov.au/aviation.¹

The remainder of this part provides background information on Airservices (section 1) and a summary of Airservices' draft price notification (section 2). Section 3 outlines the ACCC's role in assessing Airservices' price notifications, while the details of the next steps in the process of this assessment are contained in section 4.

1 About Airservices Australia

Airservices operates under the *Air Services Act 1995* (AS Act). It is statutory authority that is wholly-owned by the Australian Government and is a monopoly provider of air traffic control (ATC) and ARFF services in the Australian Flight Information Region (FIR). Airservices provides its services over 11 per cent of the world's surface, including the Australian FIR and international airspace over the Pacific and Indian oceans.²

In performing its functions, Airservices is required by section 9 of the AS Act to regard the safety of air navigation as its most important consideration. Under section 10, Airservices is required, where appropriate, to consult with government, commercial, industrial, consumer and other relevant bodies and organisations (including the International Civil Aviation Organization (ICAO) and bodies representing the aviation industry). The AS Act also requires Airservices to operate in a way that promotes and fosters civil aviation.

More information about Airservices is provided in appendix C.

¹ www.accc.gov.au/aviation > Airservices Australia > Price notifications.

² Airservices Australia, *Annual report 2009-10*, p. 8.

2 Airservices Australia's draft price notification

Airservices' draft price notification proposed maximum price increases for TN and ARFF services of 5 per cent and 12.5 per cent respectively in any single year over the period 2011-12 to 2015-16. Charges for en route services remain unchanged. Airservices' draft price notification also proposed some changes to its pricing methodology and structure.

A summary of the proposed weighted average price changes and changes to charging arrangements is contained in Airservices' draft price notification and have been reproduced in tables 2.1 and 2.2. The details of Airservices' proposed prices and formulas for calculating charges are also set out in its draft price notification and have been reproduced in appendix A.

Table 2.1: Airservices' proposed weighted average price changes (per cent)

Service	2011-12	2012-13	2013-14	2014-15	2015-16
TN	1.9	0.8	0.1	(0.1)	0.2
En route	0.0	0.0	0.0	0.0	0.0
ARFF	7.8	8.6	6.6	5.1	2.5
Weighted average (nominal)	1.8	1.6	1.0	0.8	0.5
Weighted average (real)	(1.0)	(1.4)	(2.0)	(2.2)	(2.5)

Source: Airservices Australia, *Draft price notification*, March 2011, p. 4.

Table 2.2: Summary of Airservices' proposed changes to charging arrangements

Service	Current charging arrangements	Proposed charging arrangements
TN	<ul style="list-style-type: none"> ▪ Levied on IFR and VFR full stop landings and practice instrument approaches ▪ Based on aircraft weight (MTOW) ▪ Capital city basin pricing ▪ Price capping at GA and regional locations 	<ul style="list-style-type: none"> ▪ As per current charging arrangements <p><u>Plus:</u></p> <ul style="list-style-type: none"> ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t ▪ Price capping across all locations
En route	<ul style="list-style-type: none"> ▪ Levied on IFR flights only ▪ Based on aircraft weight (MTOW) and distance flown 	<ul style="list-style-type: none"> ▪ As per current charging arrangements <p><u>Plus:</u></p> <ul style="list-style-type: none"> ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t

Service	Current charging arrangements	Proposed charging arrangements
ARFF	<ul style="list-style-type: none"> ▪ Applies to aircraft with MTOW > 15.1t or “target” aircraft with MTOW between 5.7t and 15.1t ▪ Levied on full stop landings and practice instrument approaches ▪ Based on aircraft weight (MTOW) and aircraft ARFF category 	<ul style="list-style-type: none"> ▪ As per current charging arrangements <p><u>Plus:</u></p> <ul style="list-style-type: none"> ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t ▪ Call-out charge for non-aviation false alarms
General Aviation	<ul style="list-style-type: none"> ▪ Charges under standard contract or light aircraft option (LAO) 	<ul style="list-style-type: none"> ▪ Cessation of LAO ▪ Simplification of charging ▪ Free access for low volume general aviation users ▪ Fixed price option available

Source: Airservices Australia, *Draft price notification*, March 2011, p. 16.

Airservices stated that, to balance the risks associated with a long-term pricing approach, its price proposal includes risk sharing in relation to three major factors: flight activity; capital expenditure; and regulatory change. Airservices state that these risk sharing arrangements are intended to reduce excessive over- or under-recovery of costs, hold Airservices accountable for delivering appropriate capital investment, and make provision for cost changes associated with currently unknown regulatory changes.³

3 The ACCC’s role in the regulation of Airservices Australia

The provision of TN, en route and ARFF services by Airservices are declared to be notified services under section 95X of the *Competition and Consumer Act 2010* (CCA).⁴ The relevant declaration, Declaration no. 66, is available on the ACCC’s website at: www.accc.gov.au/aviation.⁵

3.1 The ACCC is responsible for assessing Airservices Australia’s price notifications

A declared firm cannot raise the price of declared services beyond its peak price of the previous 12 months unless it first notifies the ACCC of a proposed price increase and the terms and conditions of supply. Following the lodgement of the price notification,

³ Airservices Australia, *Draft price notification*, March 2011, p. 4.

⁴ The declaration originally had effect under section 21 of the *Prices Surveillance Act 1983* (PS Act). On 1 March 2004, the PS Act was repealed and the declaration was taken to have effect under Part VIIA of the *Trade Practices Act 1974* (TPA). On 1 January 2011, the TPA was renamed the *Competition and Consumer Act 2010*.

⁵ www.accc.gov.au/aviation > Airservices Australia > Declaration No. 66.

there is a price-freeze period of 21 days. The ACCC is then responsible for assessing the proposed price increase.

The price-freeze period ceases when:

- the ACCC advises it does not object to the proposed price increase
- the declared firm agrees to implement a lower price specified by the ACCC⁶
- the prescribed period – initially 21 days – expires⁷.

The ACCC has the option of recommending an inquiry to the minister if the outcome of the procedure is perceived to be unsatisfactory.

As set out in section 95ZB of the CCA, there is an ‘applicable period’ of initially 21 days within which the ACCC is to make its assessment, starting on the day on which the formal price notification is lodged.

However, price notifications are often complex. Therefore, the ACCC suggests that a declared firm submit a draft price notification for consideration prior to lodgement of a formal price notification. This provides the declared firm and the ACCC with sufficient opportunity to consult with each other (and other parties where appropriate) to consider all relevant issues involved in the price proposal, and to ensure that all information requirements supporting the proposal are satisfied.

Although a declared firm is only required under Part VIIA of the CCA to submit a proposed price in its price notifications, the ACCC has encouraged Airservices to also include future price paths (see section 6.1), which it considers to be relevant in its assessment of the price notification against the relevant criteria in the CCA (see section 3.2).

Where a declared firm first submits a price notification that includes a long-term price path, the ACCC will conduct a detailed assessment of the substance of the proposed prices over the full period covered by the price path. The ACCC will then make a decision on the proposed prices covering the first year of the period. The declared firm will be required to submit locality notices for each of the subsequent years covered by the price path. For those subsequent years, the ACCC may consider it appropriate to conduct a short-form assessment process.

A detailed outline of the ACCC’s suggested process for all price notifications, including a discussion of short-form assessments, is contained in the ACCC’s

⁶ In circumstances where the ACCC has given a response notice under subsection 95Z(6)(c) of the CCA the price- freeze period is extended by 14 days.

⁷ Pursuant to subsection 95ZB(2) of the CCA the ACCC may specify a longer price-freeze period with the consent of the person who gave the locality notice. In circumstances where the ACCC has given a response notice under subsection 95Z(6)(c) the period is also extended by 14 days.

Statement of regulatory approach to assessing price notifications (June 2009), which is available on the ACCC's website at: www.accc.gov.au.⁸

3.2 The statutory criteria for assessing price notifications

In exercising its powers and performing its functions, subsection 95G(7) of the CCA requires the ACCC to have particular regard to the need to:

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

The ACCC considers that the criteria in subsection 95G(7) will generally be met by economically efficient prices that reflect:

- an efficient cost base
- a reasonable rate of return on capital.

In addition to these factors, a price notification may raise other issues which are relevant to the ACCC's assessment, such as the allocation of costs between declared and non-declared services and the structure of prices.

The ACCC's approach to the interpretation of the statutory criteria and assessment of price notifications is provided in appendix D. More detailed information is included in the ACCC's *Statement of regulatory approach to assessing price notifications* (June 2009), which is available on the ACCC's website at: www.accc.gov.au.⁹

4 Next steps in the process of assessment

The ACCC aims to release its final decision in September 2011 and is now seeking comments on this preliminary view.

To facilitate an informed, transparent and robust consultation process, the ACCC prefers that all submissions are publicly available. Accordingly, submissions will be treated as public documents and posted on the ACCC's website, unless prior arrangements are made with the ACCC to treat the submission, or portions of it, as confidential.

⁸ www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

⁹ www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

The ACCC will accept submissions by email (preferred) or by post. If submissions are provided in PDF format, parties are asked to also provide a copy in Microsoft Word format.

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Following this consultation process, the ACCC will consider submissions received before inviting Airservices to submit its formal price notification. Following receipt of a formal price notification, the ACCC has 21 days in which to release a final decision.

Part B: The ACCC's assessment

The ACCC approaches its assessment of price notifications drawing on the principles of economic efficiency. This includes assessing the incentives of the firm to operate efficiently. It also involves using a cost-based building-block methodology to estimate whether forecast prices reflect efficient costs.

The price increases in Airservices' draft price notification are primarily driven by cost increases—both capital and operating. It is therefore fundamental to the ACCC's assessment of this proposal that it understands the incentives that Airservices faces to operate efficiently. As a government-owned business, Airservices faces both financial and non-financial incentives. Understanding these incentives allows judgements to be made about the likely efficiency with which Airservices operates and invests. **Section 5** therefore discusses the efficiency of the cost base in the context of incentives and risks.

Section 6 assesses Airservices' activity forecasts, which are used to derive prices.

Section 7 assesses Airservices' costs and proposed revenue using the building-block model. This discussion draws in the discussion of incentives in section 5. The ACCC has used the building-block model to assess the amount of revenue required to cover the total costs of an efficient service. The required revenue under the building-block model is calculated as the sum of operating costs, return on capital, return of capital (depreciation) and an allowance for tax. The building-block model provides a framework for deriving the aggregate level of revenue, which can then be translated into individual prices using activity forecasts.

In Airservices' draft price notification, prices have been developed on a number of bases, including cost recovery, standard costing, operational efficiency and incentives for using certain aircraft types. The structure of prices can have important implications for the efficient use of and investment in services. This is discussed in **section 8**.

5 Efficiency of the cost base: incentives and risks

As discussed above, the ACCC is interested in the processes that provide Airservices with an incentive to operate efficiently. Ideally, a firm will have both internal and external processes that provide non-financial incentives. This is important for establishing the efficiency of Airservices' cost base. It is also important for the ACCC to understand the risks that Airservices bears, which has a direct effect on its financial incentives in the form of return on capital.

Therefore, in assessing Airservices' draft price notification, the ACCC has considered the extent to which the following aspects of the draft price notification provide information about Airservices' risks and incentives for efficiency:

- long-term pricing agreement (section 5.1)
- risk-sharing arrangements (section 5.2)
- performance measurement and monitoring tools (section 5.3)

- internal incentives for efficiency (section 5.4)
- formal consultation mechanisms (section 5.5)
- international benchmarking (section 5.6).

Section 5.7 provides a summary of the ACCC's assessment of these aspects.

5.1 Long-term pricing agreement

The ACCC favours the development of a long-term pricing agreement (LTPA), in consultation with its users, in preference to a short-term rate of return approach to seeking a review of prices. The ACCC considers that this approach can provide an incentive for a declared firm to reduce its costs and increase productivity beyond the pre-determined level. Long-term pricing agreements can also provide some certainty to users regarding the timing and size of expected future price rises.¹⁰

5.1.1 Airservices' position on long-term pricing agreement

Airservices submitted a five-year draft price notification, which is intended to cover the period 2011-12 to 2015-16, based on the application of the building-block model. Airservices stated that its draft price notification was consistent with the ACCC's favoured long-term approach to pricing.¹¹

Airservices submitted that the price proposal will provide industry with pricing certainty over a reasonable period of time. Airservices noted in its draft price notification that it has consulted extensively with industry since its 2004-05 LTPA and stated that industry has identified the 2004-05 LTPA as being 'largely successful in providing certainty' over pricing.¹²

Further, Airservices stated that the LTPA will promote productive efficiency by creating incentives for Airservices to achieve even higher cost reductions than forecast as its prices will not immediately be reduced to the lower level of costs.¹³

5.1.2 Views of interested parties on long-term pricing agreement

The ACCC sought comment from interested parties on the appropriateness of the LTPA.

In general, stakeholders indicated general support for the five-year price period as it provides industry with an appropriate level of price certainty. However, several stakeholders submitted that the pricing period does not provide Airservices with appropriate incentives to achieve greater cost reductions, or that the efficiency targets it

¹⁰ ACCC, *Statement of regulatory approach to assessing price notifications*, June 2009.

¹¹ Airservices Australia, *Draft price notification*, March 2011, pp. 28-29.

¹² Airservices Australia, *Draft price notification*, March 2011, p. 8.

¹³ Airservices Australia, *Draft price notification*, March 2011, p. 29.

does contain are not challenging enough (for example, IATA, Cathay Pacific, RAAA, Virgin Australia Group of Airlines (VAA), Qantas, BARA).

Air New Zealand stated that the five-year period will provide Airservices with incentives to achieve efficiency.

Qantas argued that there was an incentive for Airservices to be conservative with activity forecasts and include costs of all potential projects or services in the capital expenditure profile as well as a contingency buffer for costs.

BARA stated that the period is unlikely to have any meaningful incentives for Airservices to achieve cost reductions because most of the cost increases at domestic and general aviation airports are funded through charges at major international airports.

VAA also questioned Airservices' ability to deliver a large program of capital works given the 10 per cent over-run on the TAAATS initiative (representing \$20 million).

5.1.3 ACCC's views on long-term pricing agreement

The ACCC welcomes Airservices' long-term approach to pricing and notes stakeholders' general support for the LTPA.

The ACCC considers that this approach provides some certainty to users regarding the timing and size of expected future price rises. Also, in comparison to short-term approaches, it exposes Airservices to more risk associated with the management of costs, as well as risk associated with the variability of activity over a number of years. Exposure to such risk is an important discipline on management decisions over the timing and extent of new investment. Risk-sharing arrangements are discussed further in section 5.2. Establishing a LTPA also provides information that can be used for future benchmarking of performance.

However, the ACCC also notes concerns raised in submissions that the LTPA could provide Airservices with an incentive to overestimate costs, which are used to support its case for price increases.

The ACCC acknowledges that, in establishing LTPAs, a firm may seek to overestimate costs and, therefore, seek higher price rises. However, the ACCC considers that such outcomes can be partly mitigated by ensuring that there are additional processes in place which act as an incentive on the firm to operate efficiently. The remainder of section 5 discusses in greater detail these additional processes. Of particular relevance to this point, the ACCC notes that the risk-sharing arrangements embodied in Airservices' draft price notification (see section 5.2) provide a mechanism for returning funds to users where capital expenditure costs have been overestimated in the LTPA. Although, the ACCC considers that there is scope for Airservices to further develop this mechanism to provide incentives to manage costs on a project-by-project basis.

On balance, the ACCC remains of the view that there are significant benefits in establishing a LTPA. Consistent with the ACCC's *Statement of regulatory approach to assessing price notifications*, the ACCC endorses Airservices' approach to submitting a five-year price proposal. The ACCC notes that, as set out in the legislative framework (section 3.1), Airservices will be required to submit to the ACCC annual locality

notices corresponding to price increases for each year covered by the five-year price proposal.

5.2 Risk-sharing arrangements

There are a number of risks that are inherent in establishing a LTPA, which include:

- changes in activity from forecasting errors and unforeseeable exogenous shocks
- the risk of under- and over-runs in operating costs and capital expenditure
- technological obsolescence risks, such as the optimal timing uptake of new technology
- the risk of changes to government regulation.

It is generally desirable for such risks to be borne by the party that can most efficiently manage those risks.¹⁴

Incorporating explicit risk-sharing arrangements in a LTPA can provide transparency to the level of risk borne by each of the parties. The ACCC notes that this informs its consideration of the reasonableness of the rate of return on capital that a declared firm is seeking. Further, by setting clear expectations about the response to a risk-sharing event, the arrangements can provide non-financial incentives for a firm to operate efficiently.

5.2.1 How do the risk-sharing arrangements work?

Airservices' risk-sharing arrangements provide a process for a review of prices where there are significant differences in flight activity, capital expenditure, regulatory change and new services from those expected in its price notification. More specifically, Airservices is expected to return earnings to customers where activity is higher, or costs lower, than expected. The ACCC notes that, in the opposite case, any proposal by Airservices to increase prices is required to be notified to, and assessed by, the ACCC (see the legislative framework in section 3).

The following provides a summary of the current risk-sharing arrangements:

- Activity—where differences in flight activity result in a variance of more than a specified threshold (i.e. 5 per cent) from proposed revenue, a risk-sharing event is triggered. This event results in either a rebate to customers for the revenue above the threshold, or provide an opportunity to re-price services (subject to ACCC review) if revenues fall by more than the threshold.
- Short-falls in capital expenditure—a risk-sharing event is triggered where capital expenditure does not meet an agreed threshold (i.e. 80 per cent of expected capital expenditure). This event results in a rebate to customers.

¹⁴ ACCC, *Airservices Australia draft price notification; Issues paper*, April 2011, p. 14.

- Regulatory change—where changes in regulation result in changes in costs (i.e. new or increased levels of service), a risk-sharing event is triggered. Where new or increased levels of service were expected and included in the price notification, but do not eventuate due to changes in regulation, funds are returned to industry. Where regulations require new or increased levels of service that were not expected, then Airservices can seek to increase prices to cover costs (subject to ACCC review).

5.2.2 ACCC’s previous decisions on risk-sharing arrangements

In its assessment of Airservices’ 2004-05 LTPA, the ACCC noted that it was unclear as to whether Airservices was taking on any additional level of risk than it otherwise would have under a short-term pricing arrangement.

This was because the risk-sharing arrangements embodied in Airservices’ price notification were not prescriptive, but rather included a number of trigger points, the meeting of which obliges Airservices to consult with industry on the best means of dealing with the impact of the event. The consultation process could result in one of a number of possible responses. For example, Airservices may absorb reductions in revenue arising from a reduction in activity, or it might seek to increase prices. Therefore, it was unclear in practice what the resulting sharing of risks would be.

The ACCC also noted that there could be merit in Airservices and particular airports entering into individual risk-sharing arrangements. Airports which would be most likely to benefit from this type of arrangement are the smaller regional airports where significant change in activity is expected.

5.2.3 Airservices’ position on risk-sharing arrangements

Airservices stated that, whilst a LTPA provides price certainty, risk-sharing arrangements are important in mitigating some of the risk to itself and its users inherent in estimating costs and flight activity volumes over longer periods.¹⁵

To mitigate some of the risk, Airservices noted that its draft price notification incorporates a continuation of the risk-sharing arrangements between Airservices and its users, with some proposed amendments to the trigger mechanisms for a review of pricing. Table 5.1 summarises Airservices’ proposed risk-sharing arrangements.

Table 5.1: Airservices’ proposed trigger mechanisms for a review of pricing under its risk-sharing arrangements

Current trigger mechanism	Proposed trigger mechanism
Where flight activity volumes result in surpluses or deficits that exceed 5 per cent of the proposed revenues.	No change proposed.
Where shortfalls in capital expenditure are either less than 50 per cent of agreed	Where shortfalls in capital expenditure are either less than 20 per cent of agreed

¹⁵ Airservices Australia, *Draft price notification*, March 2011, p. 16.

Current trigger mechanism	Proposed trigger mechanism
expenditure in a single year, or less than 25 per cent of agreed capital expenditure on a cumulative basis.	expenditure in a single year, or less than 10 per cent of agreed capital expenditure on a cumulative basis.
Where regulatory changes lead to operating cost changes or require new investment.	No change proposed.
	The introduction of new services to have a three month grace period from the services' commencement date before charging begins. Prices for new services will then be reviewed after 12 months to determine whether there has been a significant change in flight activity volumes.

In relation to its proposed amendment to the trigger mechanism for shortfalls in capital expenditure, Airservices provided a summary of the resulting trigger points in its draft price notification, which has been reproduced in table 5.2.

Table 5.2: Risk-sharing trigger points for shortfalls in capital expenditure

Capital expenditure	2011-12	2012-13	2013-14	2014-15	2015-16
Annual capital expenditure proposed	206	187	194	186	185
20% annual risk threshold	185	168	174	168	166
Cumulative capital expenditure proposed	206	392	586	773	958
10% cumulative risk threshold	n/a	353	528	695	862

Source: Airservices Australia, Draft price notification, March 2011, p. 50.

Airservices submitted that its risk-sharing arrangements recognise that, where it faces higher or lower costs as a result of an unexpected change in a key factor impacting on costs, then the costs or benefits of such changes should be shared with Airservices' customers. Airservices noted that, where a change in these factors falls below certain thresholds, or there is a change in other factors, then Airservices will bear the full impact of those changes in its bottom line.

Airservices submitted that the risk-sharing arrangements provide an incentive for it to seek to minimise any resulting upward impact on costs. Only where there is a change in one of the risk-sharing factors that is so large as to be unreasonable to expect Airservices to be able to absorb the change or to gain a windfall reward from the change is a risk-sharing event triggered.¹⁶

Further, Airservices noted the asymmetric nature of the risk-sharing arrangements. In particular, Airservices stated that it returns earnings to its customers where activity is

¹⁶ Airservices Australia, *Draft price notification*, March 2011, p. 37.

higher, or costs lower, than expected but that there is no agreed mechanism for how Airservices could be compensated in the reverse scenario. Airservices regarded it as unlikely that it would be able to secure higher prices in this scenario.¹⁷

5.2.4 Views of interested parties on risk-sharing arrangements

The ACCC sought comment from interested parties on the appropriateness of the risk-sharing arrangements, particularly relating to the trigger mechanisms for review of pricing. The ACCC also sought to understand the extent to which Airservices' proposed changes to the risk-sharing arrangements would result in an increase or a decrease in the risks borne by Airservices and its users.

Submissions from interested parties generally expressed support for the risk-sharing arrangements, although some submissions raised concerns that the trigger mechanisms still provide Airservices with little incentive to tightly control capital expenditure.

Cathay Pacific Airways, Air New Zealand, RAAA and Rex all stated their support for Airservices' proposed risk sharing arrangements.

IATA stated that it supported Airservices' risk sharing arrangements. However, IATA noted in relation to revenue risk sharing that:

Airservices only bears the full risk when traffic deviates with the bands (from -5 per cent to 5 per cent). Airservices bears no risk outside this band as a price review will be triggered. Such arrangement significantly reduces Airservices' overall business risk, and therefore should also be reflected through a reduced cost of capital.¹⁸

Gold Coast Airport submitted that it would like to know how, if any over-recovery occurs, it would be distributed so that Gold Coast Airport customers benefit.

BARA submitted that it 'does not object to Airservices' proposed trigger mechanisms for capital expenditure and regulatory changes' but that it does object to Airservices 'increasing the prices of TN and ARFF services at major international airports in response to traffic downturns'.¹⁹ On this point, BARA submitted that it is difficult to accept any price increases on international airlines during an unplanned downturn when they are still likely to be over paying for the services they use at current prices. In addition, BARA stated that it does not support Airservices providing grace periods for new services because providing grace periods on prices to domestic airlines when international airlines continue to be heavily overcharged is unjustified.

VAA agreed with risk sharing in relation to flight activity volumes but did not support increases in price where volumes are lower than the forecast as the risk should be borne by Airservices. In relation to capital expenditure risk sharing, VAA submitted that it would be beneficial to have sight of major business cases before sign-off and also to receive financial statements.

¹⁷ Airservices Australia, *Draft price notification*, March 2011, p. 49.

¹⁸ International Air Transport Association, *IATA submission in response to the ACCC issues paper on Airservices Australia's draft price notification*, 10 May 2011, p. 12.

¹⁹ Board of Airline Representatives of Australia Inc., *Response to ACCC Airservices Australia draft price notification issues paper*, May 2011, p. 13.

The Qantas Group submitted that the risk sharing arrangements need further review as it is still ineffective at preventing prefunding and sharing risk. The Qantas Group stated that the arrangements are ‘somewhat one sided and do not effectively share the risk for activity and capital expenditure’ and ‘may also drive undesirable conservative cost and activity forecasts’. The Qantas Group stated that the current structure provides little incentive for Airservices to tightly control capital expenditure and provides little disincentive for warehousing of assets in order to reach capital spend targets.

5.2.5 ACCC’s views on risk-sharing arrangements

The ACCC welcomes Airservices’ continuing commitment to its risk-sharing arrangements. In particular, the ACCC notes that stakeholders generally expressed support for the continuation of these arrangements. However, in light of the proposed amendments to the trigger mechanisms for capital expenditure and new services (see table 5.1), the ACCC considers it important to understand whether Airservices’ incentives to operate efficiently and level of risk might have changed. As previously discussed, the incentive to operate efficiently is relevant to the ACCC’s consideration of the efficiency of Airservices’ cost base, while the level of risk is relevant to the return on capital discussion in section 7.4 of this paper.

Activity and regulatory changes risk-sharing arrangements

Airservices did not propose any change to its existing activity or regulatory changes risk-sharing arrangements. The ACCC also notes stakeholders’ general support for these arrangements.

The ACCC notes that, unlike the risk-sharing arrangements in relation to capital expenditure (see below), these risk-sharing arrangements do not specifically provide Airservices with an incentive to operate efficiently. Rather, these arrangements provide an avenue for Airservices to consult with its users on the best means of dealing with the impact of the event. As discussed in section 5.2.2, the consultation process could result in one of a number of possible responses. Therefore, it is unclear in practice what the resulting sharing of risks would be.

The ACCC considers that, because there has been no change to the arrangements, Airservices has not taken on additional level of risk in its draft price notification in relation to its activity and regulatory changes risk-sharing arrangements. This is relevant to the return on capital discussion in section 7.4. The ACCC remains of the view discussed in section 5.2.1 that there may be merit in Airservices and particular airports entering into individual risk-sharing arrangements. This is relevant to the activity forecasts discussed in section 6.

Trigger mechanism for shortfalls in capital expenditure

Airservices submitted that the proposed trigger mechanism for shortfalls in capital expenditure is designed to hold Airservices accountable for delivering appropriate capital investment. The ACCC considers that there are three questions in relation to Airservices’ risk and incentives for efficiency, which are outline below.

The first question is: does the trigger mechanism provide an incentive for Airservices to undertake prudent investment?

The ACCC notes that the trigger mechanism for shortfalls in capital expenditure does not take into consideration of the extent to which the capital expenditure undertaken meets the expected outcomes of the projects agreed to with users. For example, although the dollar amount of capital expenditure might meet expected levels, the appropriateness (such as quality and functionality) of the capital expenditure undertaken is not considered under this trigger. As such, the ACCC considers that the trigger mechanism for shortfalls in capital expenditure does not, of itself, provide an incentive for Airservices' to undertake prudent investment. The prudence of Airservices' capital expenditure is further considered in other parts of section 5, particularly in relation to consultation on capital expenditure in section 5.5.

The second relevant question is: does the trigger mechanism provide an incentive for Airservices to manage the risk of cost over-runs and efficiently undertake investment?

The ACCC notes that the trigger mechanism for shortfalls in capital expenditure provides some incentive for Airservices to manage the risk of cost over-runs because Airservices is expected to absorb, in the short-term, the impact where actual total expenditure is greater than projected until it is in a position to seek price increases to cover costs (i.e. at the establishment of a new LTPA).

For example, as illustrated in table 5.2, a risk-sharing event would be triggered in 2012-13 under the proposed arrangements if total capital expenditure for the period was less than 80 per cent of Airservices proposed level of capital expenditure of \$187 million—that is, where capital expenditure is less than \$168 million. If this occurs, Airservices is expected to consult with industry on the best means of dealing with the impact of the event. Airservices submitted that it returns earnings to its users in this scenario.

In the opposite scenario, where capital expenditure is more than proposed in Airservices' draft price notification, the risk-sharing arrangements do not provide an agreed-upon mechanism for review. On this point, the ACCC notes that any proposal by Airservices to increase prices is required to be notified to, and assessed by, the ACCC (see the legislative framework in section 3).

However, the ACCC also notes that the trigger mechanism for shortfalls in capital expenditure relates to total capital expenditure and does not consider capital expenditure on a project-by-project basis. Therefore, the arrangements do not of themselves provide Airservices with an incentive to manage the risk of cost over-runs on individual projects. Indeed, stakeholders raised concerns that the arrangements provide little incentive for Airservices to tightly control its capital expenditure.

Further, the arrangements could provide an incentive to delay delivery of individual capital projects. For example, in the event that the actual costs associated with an individual project were significantly higher than projected, Airservices could seek to delay capital expenditure on another project. This would not result in a risk-sharing event being triggered if Airservices total capital expenditure for the relevant period was above the trigger point. The ACCC does, however, recognise that Airservices'

discretion to delay the delivery of projects might be limited by directions from CASA or the Minister.

The ACCC considers that, in order to provide appropriate incentives, there needs to be sufficient transparency and accountability by Airservices to its stakeholders for delivering on individual projects. As discussed in sections 5.3 and 5.5, this includes providing stakeholders with regular delivery status updates on its capital expenditure program on project-by-project basis for projects over \$10 million. This should also include a comparison of projected costs versus actual costs, which the ACCC notes is also relevant to Airservices' reconciliation of its opening asset base for future price notifications (see section 7.2).

The third question is: does the change in threshold values result in any change to the level of risk borne by Airservices?

Based on the projected capital expenditure in Airservices' 2004-05 price notification (\$542 million) and its current draft price notification (\$958 million), the ACCC has undertaken a comparison of the implied capital expenditure trigger points.

Table 5.3: ACCC's analysis of the change in implied capital expenditure trigger point (\$million)

Current trigger mechanism	Implied trigger point in 2004-05 price notification	Proposed trigger mechanism	Implied trigger point in 2011-12 price notification
Where shortfalls in capital expenditure are less than 50 per cent in a single year	271	Where shortfalls in capital expenditure are less than 20 per cent in a single year	192
Where shortfalls are less than 25 per cent on a cumulative basis	136	Where shortfalls are less than 10 per cent on a cumulative basis	96

As illustrated in table 5.3, although the proposed trigger mechanism results in a decrease in the implied trigger point for a review of pricing, a significant shortfall in capital expenditure would still need to occur before the trigger point was met. In fact, Airservices confidentially provided the ACCC with additional information in relation to its capital expenditure program. This information indicated that, in general, non-delivery on individual and, indeed, multiple projects would not result in either the single year or cumulative trigger point being reached.

As a result, the extent to which the proposed amendments may have increased the level of risk borne by Airservices is not clear. However, the ACCC considers that any increase is unlikely to result in a significant change to level of risk borne by Airservices compared to its operations in 2004-05. This is relevant to the rate of return on capital discussion in section 7.4.

Grace period for new services and a twelve month review

Airservices submitted that the introduction a three month grace period before charging begins for new services would enable volumes to be assessed to ensure that prices reflect unit costs.

The ACCC recognises stakeholders' general support for the introduction of a grace period for new services. However, the ACCC considers that the effect of this grace period is to simply delay the beginning of Airservices' recovery of costs. In particular, Airservices is still expected to recover its total costs for providing the services. As discussed in section 8.5, the ACCC considers that the timing of recovery of costs is a matter of equity between Airservices and its customers rather than a consideration of economic efficiency.

The ACCC also notes stakeholders' general support for the inclusion of a review of activity levels and pricing after twelve months. However, the ACCC considers that this has similar effect to the existing activity risk-sharing trigger.

Therefore, the ACCC does not consider that Airservices has taken on additional level of risk as a result of its proposed introduction of a grace period for new services and a twelve month review. This is relevant to the rate of return on capital discussion in section 7.4.

5.3 Performance measurement and monitoring

Incorporating explicit performance measurement and monitoring tools provide transparency and accountability to stakeholders for meeting efficient operating targets.

5.3.1 ACCC's previous decisions on performance measurement and monitoring

In its assessment of Airservices' 2004-05 LTPA, the ACCC noted its concern with the lack of formal efficiency targets and incentive mechanisms that would encourage it to reduce costs, and considered that Airservices could further develop this aspect of its pricing in future proposals.

Although, as discussed in section 5.1, the ACCC also noted that taking a long-term approach to pricing would provide incentive properties for reductions in operating expenses as well as providing a benchmark against which Airservices' customers could assess its performance over the period of the agreement.

5.3.2 Airservices' position on performance measurement and monitoring

Airservices stated that it has developed a Services Charter (the Charter) that is aimed at improving the measurement and monitoring of its performance.²⁰ Appendix 3 to the draft price notification contains the measurement metrics included in the Charter, such as key performance indicators (KPIs) and targets relating to safety, cost-effectiveness,

²⁰ Airservices Australia, *Draft price notification*, March 2011, p. 17.

capacity, flight efficiency, ARFF availability and ARFF response. It also includes details of the methodology for measurement.²¹

Airservices submitted that through the Charter, it seeks to engage stakeholders in a common understanding and agreement of current and future service delivery requirements.²² Airservices submitted that the Charter will also provide a tool for reporting on capital works to industry on a quarterly basis. Project reports will provide financial performance analysis as well as discussion of key milestones and risks. Airservices noted that performance indicators and agreed performance baselines will track project benefits over time.²³

Airservices submitted that the Charter is a work in progress and will be reviewed annually as more data becomes available and there is a better understanding of the connection between performance measures and actual service quality.²⁴

5.3.3 Views of interested parties on performance measurement and monitoring

Stakeholders welcomed the establishment of the Charter, with some qualifications and suggestions regarding its continued development.

Stakeholders expressed concerns that the Charter did not drive or measure internal efficiency gains (for example, IATA, Rex), although recognised that the Charter was in its early stages of implementation and the KPIs were under development.

Qantas supported the Charter and welcomed the opportunity to develop measures and systems within the Charter to drive improved business behaviours and performance. Qantas considered that an appropriate way to do this would be to manage and monitor expenditure collaboratively at the Pricing Consultative Committee (PCC) meetings.

5.3.4 ACCC's views on performance measurement and monitoring

The ACCC welcomes Airservices' development of the Charter, which it considers to be a positive addition to Airservices' consultation processes. Indeed, the ACCC notes stakeholders' general support for the establishment of the Charter.

The ACCC notes that the Charter is intended to enhance Airservices' consultation with stakeholders regarding desired levels of service delivery, which in turn should assist in guiding capital investment decisions as the Charter is further developed and implemented. In addition, the Charter will be an important accountability tool to ensure that any cost savings achieved are not at the expense of quality of service to users.

Further, the ACCC notes that Airservices' quarterly reports against the KPIs in the Charter incorporates a delivery status update on its capital expenditure program on project-by-project basis. This includes a comparison of projected costs versus actual costs. The ACCC welcomes this inclusion, and considers this a positive step towards

²¹ Airservices Australia, *Draft price notification*, March 2011, p.75.

²² Airservices Australia, *Draft price notification*, March 2011, p. 17.

²³ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011, p. 5.

²⁴ Airservices Australia, *Draft price notification*, March 2011, p. 17.

improving Airservices' transparency and accountability. This is also relevant to the consultation with users discussion in section 5.5.

The ACCC notes that the Charter is still in development and considers that there is still scope to strengthen the accountability for Airservices' to meet the KPIs included in the Charter. In particular, where KPIs are not met, there needs to be clear guidelines as to what Airservices' resulting response should be. Such a response could include any financial consequences for Airservices not meeting an agreed number of KPIs within a period.

The ACCC also notes stakeholders' comments regarding the lack of KPIs relating to the efficiency or productivity of Airservices' operations. The ACCC would encourage Airservices to further develop these KPIs in its Charter in consultation with its users.

5.4 Internal drivers of efficiency

Internal drivers of efficiency encompass the incentives for, and accountability of, staff and decision makers within the firm. These may include:

- a robust performance management system incorporating appropriate KPIs for staff and managers, and effective rewards and processes for accountability.
- budget processes and initiatives to drive cost savings
- formal decision-making processes to drive productivity, such as internal targets and benchmarking
- efficiency benchmarking and targets
- reporting requirements to shareholders..

5.4.1 ACCC's previous decisions on internal drivers of efficiency

In its assessment of Airservices' 2004-05 LTPA, the ACCC noted its concern with the lack of formal efficiency targets and incentive mechanisms that would encourage it to reduce costs, and considered that Airservices could further develop this aspect of its pricing in future proposals.

5.4.2 Airservices' position on internal drivers of efficiency

Airservices submitted that it had in place mechanisms that provide transparency and accountability, and drive efficiency within the business, including:

- performance management, rewards and accountabilities for staff and managers
- budget processes and initiatives
- capital works decision-making and project delivery processes.

Airservices stated that it had made efficiency gains, and improved productivity in a number of areas.

Performance management and incentives for efficiency

Airservices provided additional information to the ACCC on its performance management system for staff and managers, and described how this was aligned to its business planning.²⁵ Airservices stated that individuals' performance across a number of objectives was tied to consideration for salary increments, and for senior managers to levels of performance-based pay.

Budget process

Airservices provided additional information to the ACCC regarding its budgeting process.²⁶ Airservices submitted that Groups within the business are required to establish and maintain cost optimisation programs to identify and capture business efficiencies. Airservices stated that it had dedicated business improvement and corporate efficiency cells.

Capital investment decision making processes

Airservices provided additional information to the ACCC, which outlined the process for the development and delivery of Airservices' capital works.²⁷

Airservices described the planning components of its Capital Works Program, which both identify corporate priorities, and map the current and projected internal and external strategic influences on Airservices to the short and long term investment required to enable it to develop appropriate organisational and service capabilities. Airservices submitted that the planning documents look out five to 15 years and are reviewed annually.

In additional information provided to the ACCC, Airservices described the formal internal processes to be undertaken for approval of capital works, which included:

- Review and approval of the overall plan by the Airservices Board
- Investment Committee (members of Airservices Executive and CEO) monitors the planning and delivery of all expenditure (both capital expenditure and operating expenditure)
- Implementation of its Standard Project Management Methodology
- Project Governance Groups to support the decision making process throughout the life of the project, including appropriate review.

Airservices stated that from a consultative and financial accountability perspective, the nature and value of the project triggers the level of the decision making authority

²⁵ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011.

²⁶ Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011.

²⁷ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011.

required. Under Airservices' delegation framework, different managers can endorse varying levels of expenditure and the Board must endorse expenditure over \$10 million. Civil works projects exceeding \$15 million must be endorsed by the Federal Parliament's Public Works Committee.

Airservices stated that it reports on capital works performance to the Minister for Infrastructure and Transport on a quarterly basis.

Areas where Airservices states it has achieved efficiency and made productivity gains

Airservices has provided in the draft price notification, and in response to information requests by the ACCC, examples to support claims it has improved its cost effectiveness through continuous business improvement and efficiency initiatives, as well as some improved productivity of capital assets.

Airservices submitted that it has delivered real price reductions of 40 per cent since 2001. Airservices submitted that it has undertaken whole-of-business cost reform. It stated that it has made significant real decreases in unit costs for each of the three major services over the pricing period, despite upward pressure on costs.

In the draft price notification, and in subsequent additional information as requested by the ACCC, Airservices provided the following to support its claims:

- Replacement of end-of life infrastructure has enabled savings on forecast cost increases from higher maintenance and obsolescence that would have occurred if not replaced, and have provided additional capacity in supporting systems to allow for the higher levels of traffic to be processed more efficiently.²⁸
- Airservices submitted that growth in costs for national airways infrastructure repairs and maintenance have averaged 1.6 per cent per annum over the last six years, which it stated, represents a real saving of 6.4 per cent.²⁹
- ARFF training reform has provided savings of 18 per cent in training costs since 2006 and savings in foam usage of nearly 35 per cent, despite the introduction of four new fire services.³⁰
- Modernisation of ARFF vehicle fleet: unit fire vehicle repair costs have remained constant since 2006, providing real savings of 16 per cent.³¹
- To improve efficiency Airservices noted it had acquired a new rostering tool which will enable it to better utilise staff resources.³²
- Improvements to ATC resource management capability will increase ATC flexibility and efficiency by allowing each controller to be authorised to

²⁸ Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011, p. 5.

²⁹ Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011, p. 5.

³⁰ Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011, p. 5.

³¹ Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011, p. 5.

³² Airservices Australia, *Draft price notification*, March 2011, p. 35.

perform the ATC function across more operating volumes or controller positions.³³

5.4.3 Views of interested parties on internal drivers of efficiency

Stakeholders' concerns regarding internal processes for efficiency have been encapsulated to some extent in broader concerns relating to lack of transparency (through consultation), lack of formal or explicit efficiency targets and appropriate benchmarks, as noted in more detail above.

IATA considered that a correct understanding of how Airservices performed against targets in previous agreements should be provided. IATA did not believe that the operating costs proposals represented any efficiency improvements. It proposed that Airservices keep its operating costs consistent (in nominal terms) throughout the period if it is not able to agree on a relevant benchmarking methodology with stakeholders.

BARA submitted that Airservices had 'made little if no effort to improve the level of transparency over its operating costs or [to] investigate the possibility of introducing formal efficiency targets'.³⁴ As a result, BARA stated it was not in a position to provide meaningful input into the ACCC's assessment of Airservices' operating costs.

5.4.4 ACCC's views on internal drivers of efficiency

In its draft price notification, and additional information to the ACCC, Airservices has provided details regarding performance management and incentives for staff and management, budget processes, decision making processes for capital investment, and other initiatives to bring about efficiency gains.

The ACCC has reviewed this information and is satisfied that Airservices has in place a performance management framework for employees, which is supported by system of financial rewards and accountabilities for performance. In addition, the ACCC is satisfied that Airservices has appropriate budget processes and decision-making processes in place for capital investment decisions. The ACCC considers these to be appropriate formal checks and balances to have in place within the organisation. However, the ACCC notes that it has relied on the advice of Airservices' staff in relation to how robustly those formal processes are implemented.

The ACCC notes stakeholders concerns regarding their inability to make an assessment of the efficiency of Airservices' cost base, and efficiency of operating costs. As noted above, the ACCC has in past decisions considered that Airservices could go further to develop formal incentives for efficiency. These could be in the form of internal benchmarking and explicit efficiency targets.

In its 2004-05 assessment, the ACCC considered that the LTPA would provide a benchmark against which its customers could assess Airservices' performance over the

³³ Airservices Australia, *Draft price notification*, March 2011, p. 35.

³⁴ BARA, *Response to ACCC Airservices Australia Draft Price Notification Issues paper*, May 2011, p. 11.

period of the agreement. Internal benchmarking would enable a reasonableness check on growth of costs through observation of patterns in costs, expenditures, prices, capacity and activity over time. This exercise should provide continuous information, including between the end of a formal price agreement and subsequent ACCC assessment of any proposed price increases.

Internal benchmarking would not in itself, however, provide an insight into the level of efficiency at which Airservices operates or invests. The ACCC noted in 2004-05 that the introduction of the long term pricing agreement represented the first steps towards introducing a formal incentive to reduce costs by making transparent cost estimates for the following five years.

At that time, the ACCC encouraged Airservices to consider introducing initiatives such as a CPI-X price cap in future long term pricing proposals.³⁵ The CPI-X model can be effective in driving efficiencies and providing a check on the growth of a firm's operating costs. The ACCC remains of the view that there is scope for Airservices to build explicit efficiency targets into the LTPA prices, which may include the implementation of CPI-X.

The ACCC is also mindful that such efficiency targets, of themselves, will not provide incentives for prudent and efficient capital expenditure.

5.5 Consultation with users

As discussed in section 5.1, there is an incentive for firms establishing LTPAs to overestimate costs. The ACCC considers that Airservices' stakeholders are in a strong position to advise whether or not Airservices' proposed capital expenditure is prudent and efficient. Therefore, in considering Airservices' draft price notification, it is important for the ACCC to understand the extent to which Airservices' proposed capital expenditure has been consulted on with its stakeholders, as well as the extent to which the proposal is supported by those parties.

Further, the ACCC is interested in understanding the processes that Airservices has in place for ongoing consultation with its stakeholders. Formal mechanisms for consultation with users play an important role in providing ongoing transparency to, and accountability for, Airservices' performance.

5.5.1 ACCC's previous decisions on consultation with users

In its assessment of Airservices' 2004-05 LTPA, the ACCC encouraged Airservices to increase the transparency and analytical rigour of its decision-making associated with its choice of capital expenditure projects. The ACCC considered it was important for Airservices to detail the consultative and decision-making processes it had in place to ensure the prudence and efficiency of capital expenditure projects. Further, the ACCC

³⁵ 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, in theory, users of the regulated business also benefit from the costs reductions from expected productivity growth being passed on and reflected in prices.

noted that stakeholders wanted to see how future savings associated with new capital equipment were being reflected in Airservices' cost structure.

5.5.2 Airservices' position on consultation with users

Airservices submitted that it has conducted extensive consultation with stakeholders in relation to both the price notification and other projects, and has taken into account feedback from stakeholders in drafting the price notification.

Airservices published a version of its draft price notification via its website in December 2010 and asked for industry feedback on the proposal by early February 2011.³⁶ Airservices also established a public meeting program for stakeholders at various locations in January 2011.³⁷

Airservices stated that it has provided stakeholders with sufficient information, including comprehensive information packs on capital expenditure, detailed forecast operating costs by services and a detailed report supporting the activity forecasts.

Airservices submitted that the provision of information was supported by regular PCC meetings with representatives from major domestic and regional carriers, international airlines and associations, and general aviation operators. Airservices stated that it had made offers for its senior engineering and operation staff to provide more detailed briefings on individual projects in the capital expenditure program, however these offers had not always been taken up by users.³⁸

Airservices stated that the PCC played an important role in developing prices for the current price proposal, and more recently has discussed the core pricing inputs such as the forward capital works program, Weighted Average Cost of Capital (WACC), forecast activity and costs for the price proposal.³⁹

Airservices submitted that it had recently published the Charter (see section 5.3), through which it seeks to engage stakeholders in a common understanding and agreement of current and future services delivery requirements. It submitted that the Charter was developed in consultation with key stakeholders in the PCC.⁴⁰

Further to the information contained in its draft price notification, Airservices provided the ACCC with information in which it committed to presenting summary business cases for all projects greater than \$10 million to the PCC. Airservices submitted that this would provide industry with more oversight and input to its options analysis and decision making.⁴¹

³⁶ Airservices Australia, *Draft price notification*, March 2011, p. 56.

³⁷ Adelaide, Brisbane Cairns, Hobart, Melbourne, Perth, Rockhampton, Sydney and Tamworth.

³⁸ Airservices Australia, *Draft price notification*, March 2011, p. 66.

³⁹ Airservices Australia, *Draft price notification*, March 2011, p. 11.

⁴⁰ Airservices Australia, *Draft price notification*, March 2011, p. 17.

⁴¹ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011, p. 5.

5.5.3 Views of interested parties on consultation with users

The ACCC sought comment on the effectiveness of Airservices' consultation processes in its development of the draft price notification. In particular, the extent to which Airservices has provided industry with sufficient information to make informed comment on capital expenditure projects.

A number of stakeholders submitted that they were satisfied with Airservices' consultation processes (for example, AOPA, Regional Express and RAAA). Cathay Pacific submitted that it was 'satisfied with the mechanical process' but not necessarily the outcome of the consultations.⁴²

However, a number of submissions raised concerns about Airservices' consultation processes in relation to capital investment projects. In particular submissions raised concerns about the timing and extent of consultation and Airservices' accountability for delivering on agreed projects. Further, a number of stakeholders called for the removal of certain projects from the LTPA.

Timing and extent of consultation

Several stakeholders (for example, IATA, VAA, Qantas, BARA) called for greater detail and transparency of investment plans, and more timely consultation. Stakeholders stated that they wished to be involved earlier in project conception stages, and required visibility of business cases for major projects together with evidence of cost effectiveness and efficiency.

BARA described Airservices' consultation since 2005 as 'ad hoc', and noted that details on the cost of providing individual services by location had been posted on Airservices' website for the 2004 LTPA.

IATA acknowledged the consultations that Airservices had conducted with stakeholders over the period of the current LTPA. However, IATA noted that information disclosure on Airservices' performance related to internal productivity and cost efficiency had been limited.

IATA also noted that consultation on capital expenditure and the resulting impact on services and functionality have not been effective. IATA considered that there had been a lack of adequate information and justification of various projects in the current capital works plan.

Qantas stated that Airservices had improved its provision of information but that the information provided 'remains at summarised high level'.⁴³ Qantas expressed concern that there were a number of projects of a non-operational nature on which it is generally not consulted in any detail. Qantas stated it was concerned about the governance surrounding these major expense items, however stated it had requested further

⁴² Cathay Pacific Airways, *Submission to ACCC issues paper*, May 2011, p. 1.

⁴³ Qantas Group, *Submission to Australian Competition and Consumer Commission Issues Paper on Airservices Australia's five year draft pricing proposal*, May 2011, p.3.

information and would track progress through the Services Charter and quarterly industry meetings.

Accountability for delivering on agreed projects

Qantas considered that there lacked a mechanism to ensure accountability for the cost, progress and efficient delivery of projects.

Gold Coast Airport stated that it was satisfied with Airservices' consultation process as well as the time Airservices has taken to analyse Gold Coast Airport's position, but was not satisfied that Airservices had adequately addressed all of its concerns.

Removal of certain projects from the LTPA

Some stakeholders (for example, Qantas, RAAA, Rex, Cathay Pacific, IATA) called for the major projects, in particular the ATM Future Systems, to be removed from the LTPA until there is more detail and certainty, with corresponding adjustments to be made to price at that time. IATA alternatively called for a shorter price period with a similar outcome being that prices are reviewed incorporating details of the project at a later date.

In addition, stakeholders sought reassurance regarding the cost effectiveness of investment decisions and delivery (for example, BARA, Qantas, IATA). Stakeholders also stated that they wished to see evidence of the costs and benefits of major projects, justification of expenditure and business cases demonstrating benefits to the industry.

5.5.4 ACCC's views on consultation with users

The ACCC acknowledges that Airservices has taken some steps since its 2004-05 LTPA to further establish consultation processes with its users. Indeed, the ACCC notes that regional and GA stakeholders appear to be relatively satisfied with Airservices' consultation processes.

However, the ACCC notes that a number of stakeholders have expressed concerns that the Airservices has not provided a sufficient level of information in its consultation with users in order for them to provide informed comment on the proposal. This concern has been raised particularly in relation to large capital expenditure projects, such as the ATM Future System project which users said should be removed from the LTPA. Further, the ACCC also notes stakeholders' concerns that Airservices' ongoing processes for consultation do not provide it with sufficient accountability for delivering on agreed projects. These matters are discussed in more detail below.

Timing and extent of consultation

As discussed above, the ACCC needs to be satisfied that Airservices' capital expenditure program is prudent and efficient. Stakeholders are in a strong position to advise whether or not this is the case. However, in light of the concerns raised by stakeholders regarding Airservices' level of consultation on its capital expenditure program, the ACCC is not satisfied that the consultation processes have been sufficient to ensure that the capital expenditure proposed in the draft price notification is prudent and efficient.

The ACCC considers that there is scope for Airservices to improve its consultation processes to allow stakeholders to provide more informed input on the benefits and costs of specific projects. Subsequent to submitting its draft notification, Airservices advised the ACCC that it had undertaken to present summary business cases for all projects greater than \$10 million to its PCC. The ACCC considers this is a positive step towards Airservices improving its consultation.⁴⁴ The ACCC considers that Airservices needs to demonstrate that it has established this process prior to it submitting its formal price notification.

As discussed in section 5.7, the extent to which Airservices continues to commit to this will be a relevant consideration in the ACCC's assessment of Airservices' annual locality notices that need to be submitted for its LTPA.

Accountability for delivering on agreed projects

The ACCC also needs to be satisfied that Airservices has formal mechanisms for consultation with users that provide ongoing transparency to, and accountability for, Airservices' performance. However, the ACCC notes that a number of stakeholders have raised concerns that its consultation processes do not provide sufficient accountability for delivering on agreed projects, or adequately addressing their concerns.

Further, the ACCC notes its comments made in relation to the risk-sharing arrangements for shortfalls in capital expenditure (see section 5.2). In particular, that the risk-sharing arrangements do not provide sufficient incentive for Airservices to deliver on individual capital projects. As discussed in section 5.3, however, the ACCC considers that Airservices' quarterly reports against the Charter, which incorporates a delivery status update on its capital expenditure program on project-by-project basis is a positive step towards improving Airservices' transparency and accountability.

In light of these comments, the ACCC considers that there is still scope for Airservices to improve its accountability for delivering on agreed projects and addressing stakeholders' comments. The ACCC considers that this can also be achieved through Airservices committing to take to its PCC details on the outcomes of consultation, such as the reasons for its decisions, as well as its continued commitment to provide updates on the progress of delivery of individual projects. In line with the above discussion regarding summary business cases, the ACCC would expect that this be done for each of the individual projects greater than \$10 million.

⁴⁴ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011.

Removal of certain projects from the LTPA

The ACCC notes stakeholders' particular concerns that the ATM Future System project has not been sufficiently consulted on with users and, therefore stakeholders have requested to have it removed from the LTPA.

Despite the ACCC's concerns about Airservices' consultation with users (see above), the ACCC considers that the removal of such projects from the capital expenditure program used to establish the LTPA may compromise the benefits of taking a longer-term approach to pricing, being the provision of pricing certainty. Moreover, as discussed in section 5.1, taking a long-term approach provides for a better sharing of risks between Airservices and users than would otherwise occur under a short-term approach to pricing.

The ACCC, therefore, considers it appropriate for Airservices to include the ATM Future System project in its LTPA. However, the ACCC notes that expenditure on this project is not expected to commence in the first year of the five year pricing period. Further, as discussed above, the ACCC notes that the extent to which Airservices commits to undertaking better consultation with users on capital expenditure projects will be relevant for its consideration of Airservices' annual locality notices that need to be submitted. The ACCC would expect that, as the details of the project become more certain, users would be provided with greater opportunity to comment on its prudence and efficiency prior expenditure commencing and prices increasing.

5.6 International benchmarking

Benchmarking is an important instrument for comparing and evaluating performance on an objective basis. By providing information about the relative performance of a firm, benchmarking can also provide an incentive for improvement in performance. However, benchmarking is only useful to the extent that the benchmarked firms operations are on a comparable basis.

5.6.1 ACCC's previous decisions on international benchmarking

In its 2004-05 assessment, the ACCC encouraged Airservices to undertake some independent and reviewable benchmarking studies with commercially oriented air traffic managers, which might further clarify the relative international efficiency of its operations. It considered this would need to be broad enough in scope to allow some assessment across all regulated activities. The ACCC also suggested that Airservices could consider the use of total factor productivity techniques such as data envelope analysis to analyse the relative efficiency of its operations against international best practice standards.

In identifying the limitations of international benchmarking, the ACCC considered that comparisons with more commercially oriented air traffic managers such as New Zealand, South Africa and the UK would be more appropriate, and that it would need to see detailed information benchmarking the performance of all significant business units within Airservices against relevant best practice standards.

In the absence of such detailed information, the ACCC suggested an alternative would be studies of historical and/or forecast total factor productivity to provide insights into Airservices' efficiency performance, especially given the potential for capital/labour substitution within the business. These could be conducted at an aggregate business level and/or for specific services lines.

5.6.2 Airservices' position on international benchmarking

Airservices submitted that it had participated in international benchmarking exercises through the Civil Air Navigation Services Organisation (CANSO), and provided excerpts of those results in its draft price notification.

Airservices submitted that, although the operating environment was unique for each country, comparative Air Navigation Service Providers (ANSPs) for Australia are Canada, New Zealand and South Africa. On this basis, Airservices submitted that it has the lowest financial cost per flight hour, with only New Zealand and Mexico having a slightly lower figure.⁴⁵

Airservices also confidentially provided the ACCC with further information in relation to its international benchmarking results.

5.6.3 Views of interested parties on international benchmarking

Stakeholders (for example, IATA, Cathay Pacific) expressed concerns that Airservices' benchmark comparisons were not comparing like-for-like service providers, and therefore it was difficult to gauge how efficient it was against other ANSPs.

IATA also argued that Airservices should set targets for operating costs that closed the gap with Airways New Zealand, which has much lower unit costs. IATA considered that in addition, Airservices should include information to show the proportion of services provided in oceanic areas by each of the comparator ANSPs, as it argued this has a significant effect on costs.

United Continental Holdings supported IATA's comments that Airservices should provide adequate benchmarking information for purposes of validating Airservices' current operating costs, its future cost growth and its own efforts to control costs and to operate in an efficient manner.

5.6.4 ACCC's views on international benchmarking

The ACCC acknowledges the points made by stakeholders in relation to the limitations of the available benchmarking data in providing accurate comparisons of ANSPs and has taken this into consideration when assigning weight to results of international benchmarking.

The ACCC is of the view that the available international benchmarking data can provide some insight into the efficiency of Airservices' operations to the extent that

⁴⁵ Airservices Australia, *Draft price notification*, March 2011, p. 35.

large or obvious differences in Airservices' results compared to other ANSPs might highlight potential areas of concern.

The ACCC has reviewed both the public and confidential information provided by Airservices and has formed the view that the results do not highlight any areas of particular concern. The ACCC notes, however, that the international benchmarking studies provided to the ACCC related only to ANSPs and did not include any information relating to ARFF services. These findings are also relevant to the discussion of operating costs in section 7.1.

5.7 Summary of risks and incentives for efficiency

The ACCC is concerned that Airservices has not undertaken adequate consultation with stakeholders to ensure that its capital expenditure program is prudent and efficient (see section 5.5). In particular, a number of stakeholders have expressed concerns relating to the timing and level of information provided by Airservices in its consultation processes.

The ACCC considers that there is scope for Airservices to improve its consultation processes to allow stakeholders to provide more informed input on the benefits and costs of specific projects. The ACCC considers that Airservices' commitment to present summary business cases for all projects greater than \$10 million to its PCC is a positive step towards improving its consultation.⁴⁶ The ACCC considers that Airservices needs to demonstrate that it has established this process prior to it submitting its formal price notification.

The ACCC considers that Airservices needs to demonstrate its commitment to providing stakeholders with a more informed input on its capital investment decisions. The ACCC considers that this can be achieved by Airservices' commitment to take summary business proposals for all capital expenditure projects worth over \$10 million to its PCC. The ACCC would expect that Airservices would include sufficient information for stakeholders in its business proposals about the expected costs, benefits and timing, as well as any assumptions, about each capital expenditure project.

The ACCC is also concerned that the processes in place were not adequate to provide Airservices' with an appropriate amount of accountability for delivering on capital expenditure projects (see section 5.2, 5.3 and 5.5). In particular, a number of stakeholders have expressed concerns that the KPIs included in the Charter do not provide explicit efficiency targets. Also, that consultation processes do not provide sufficient information for users, which was discussed above. Further, the ACCC notes that the risk-sharing arrangements relating to short-falls in capital expenditure do not effectively provide Airservices with sufficient incentive to manage costs on a project-by-project basis.

⁴⁶ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011.

The ACCC considers that there is still scope for Airservices to improve its level of transparency and accountability in relation to its performance, which in turn will provide stakeholders with a greater degree of comfort that it is operating efficiently. The ACCC considers that this can be achieved by Airservices committing to incorporating further KPIs relating to productivity and efficiency in the Charter in consultation with its users. This should be accompanied by enhancing the effectiveness of the Charter through setting of clear guidelines as to what Airservices' response should be for not meeting its KPIs.

The ACCC also expects that, in addition to taking summary business proposals to its PCC (discussed above), Airservices would be pro-active in providing its PCC with details on the outcomes of consultation. The ACCC considers that Airservices' reporting on the progress of delivery of individual projects is a positive step, and the ACCC would expect that Airservices continue to report on its actual costs versus projected costs, timing and quality or performance of the new investment.

The ACCC considers that, if Airservices can demonstrate that it has addressed these matters prior to submitting its formal price notification, then it would be minded to not object to Airservices' proposal to increase charges in the first year on this basis, subject to any necessary adjustment as a result of amendments to its return on capital (see section 7.7). The ACCC notes that the extent to which Airservices continues to commit to this will be a relevant consideration in its assessment of Airservices' annual locality notices that need to be submitted for future years in its LTPA (see the legislative framework in section 3).

These views have been an important consideration in the ACCC's assessment of Airservices' proposed activity forecasts (section 6), building-blocks (section 7) as well as its cost allocation and structure of prices (section 8).

6 Activity forecasts

Forecast activity levels have a significant and direct influence on the prices that are proposed by Airservices. In particular, forecast activity levels are used to translate Airservices' proposed revenue levels into individual prices.

6.1.1 ACCC's previous decisions on activity forecasts

In its 2004-05 assessment, the ACCC considered that Airservices' engagement of IATA to obtain an objective basis for activity forecasts and that the use of generalised growth rates was a reasonable method for developing aggregate activity forecasts across Airservices' network. However, the ACCC also considered that the activity forecasts were likely to be more accurate at the aggregate level than at an individual airport level. The ACCC therefore encouraged Airservices' commitment to considering individual risk-sharing arrangements with particular airports regarding activity levels.

6.1.2 Airservices' position on activity forecasts

Airservices' forecast activity growth rates over the five years of its proposal are based on activity growth estimates provided by IATA, with some adjustments made by Airservices. Table 6.1 summarises the adjustments made by Airservices and table 6.2 outlines Airservices' forecast activity levels and growth rates.

Table 6.1: Airservices' adjustments to IATA's forecast activity growth rates

Adjustment	Description of adjustment made	Figures affected
A380 weight capping	Adjustments were made to reduce the level of activity relating to A380 aircraft due to a reduction in the chargeable weight from 570 tonnes to 500 tonnes.	International en route traffic and major airport traffic where A380 aircraft operate.
Secondary capital city and RAAF airports	Regional airport traffic levels were adjusted to include secondary capital city ports and military ports that were not taken into account in IATA's review.	Regional traffic forecasts at Archerfield, Bankstown, Camden, Essendon, Jandakot, Moorabbin, Parafield, Darwin and Townsville airports.
High growth airports	To address feedback received through consultation that there had been recent strength in domestic traffic levels at certain airports, some traffic forecasts were revised upwards.	Domestic traffic forecasts at Cairns and Gold Coast airports.

Source: Airservices Australia, *Response to ACCC's additional information request*, 17 May 2011, p. 2.

Table 6.2: Airservices' forecast activity levels (million) and growth rates (per cent)

Traffic		2011-12	2012-13	2013-14	2014-15	2015-16
Major domestic en route (passengers)	Level	59.6	62.7	66.1	69.6	73.3
	Growth	5.0	5.3	5.3	5.3	5.3
Major domestic en route (MTOW)	Level	40.3	41.4	43.1	44.8	46.5
	Growth	4.7	2.8	4.1	3.9	3.8
Major international en route (passengers)	Level	28.6	30.3	32.0	33.9	35.8
	Growth	6.2	5.7	5.7	5.7	5.7
Major international en route (MTOW)	Level	59.8	62.1	64.5	67.7	69.9
	Growth	5.0	3.9	3.8	4.9	3.4
Major airports (aggregated) (passengers)	Level	57.8	60.4	63.1	65.9	68.8
	Growth	4.4	4.4	4.4	4.4	4.5
Major airports (aggregated) (MTOW)	Level	47.5	49.0	51.0	53.2	55.2
	Growth	5.0	3.2	4.0	4.3	3.9

Traffic		2011-12	2012-13	2013-14	2014-15	2015-16
Regional airports (aggregated) (MTOW)	Level	4.5	4.6	4.8	5.0	5.1
	Growth	1.9	3.4	3.6	3.5	3.4

Source: Airservices Australia, *Draft price notification*, March 2011, p. 71.

Airservices stated that it had undertaken a similar approach to its 2004-05 price notification in developing activity forecast that underpin this draft price notification. That is, working from an aggregate level of growth that is linked to national economic growth, implied location forecasts have then been derived. Airservices stated that this recognises that the inherent volatility in location growth is tempered by growth in aggregate demand.⁴⁷

To mitigate the risks (both to Airservices and to its users) posed by uncertainty of activity forecasts for new services, Airservices proposed a post-implementation review mechanism (discussed in section 5.2). Airservices did not propose any change to its existing activity risk-sharing arrangement, being that a review would be triggered where flight activity volumes result in surpluses or deficits that exceed 5 per cent of the proposed revenues.

Airservices noted that it had considered the issue of location risk-sharing. However, it submitted that a suitable alternative to the existing activity risk-sharing arrangements had not yet been identified.⁴⁸

6.1.3 Views of interested parties on activity forecasts

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

Interested parties generally agreed with the international activity forecasts put forward by Airservices. However, a number of domestic and regional stakeholders expressed concern that domestic and regional activity forecasts are too low.

Air New Zealand and BARA stated their acceptance of Airservices' international activity forecasts.

VAA generally agreed with Airservices' activity estimates, but noted that it would like to seek a review of forecasts on an annual basis.

The Qantas Group submitted that the international activity forecasts are 'in line with historical averages and therefore reasonable' but raised concerns that Airservices' domestic and regional activity forecasts are too low.⁴⁹

⁴⁷ Airservices Australia, *Draft price notification*, March 2011, p. 13.

⁴⁸ Airservices Australia, *Draft price notification*, March 2011, p. 50.

⁴⁹ Qantas Group, *Submission to the Australian Competition and Consumer Commission issues paper on Airservices Australia's five year draft pricing proposal*, 11 May 2011, p. 4.

RAAA and Rex submitted that forecasts for regional airport activities are conservative.

Gold Coast Airport submitted that Airservices' activity forecasts did not reflect its own forecasts, which estimate a higher growth in activity. In particular, Gold Coast Airport stated that:

The AA Draft Price Proposal dated December 2010 includes traffic forecasts for the pricing period for the eight busiest airports in Australia prepared by IATA Consulting. The paper states that the tables included in Appendix 1 – Activity Forecasts, show “the activity growth forecasts that underpin this pricing proposal”. The tables show that it is forecast that Gold Coast Airport is the only major airport in Australia that will have negative growth in the future. Whilst the forecast negative growth is for FY2011 this sets the base for the pricing period and is reflected in the tonnage forecasts. This forecast negative growth is in strong contrast to the actual performance of Gold Coast Airport over the last five years where it has consistently been the fastest growing major airport in Australia. Indeed, lack of recognition of this growth would appear to be the reason for the current excessive rate of over-recovery.

As we have indicated to AA, these forecasts are not only at odds with current trends, they are also significantly under well researched forecasts prepared by independent consultants for our Board and financiers and for airport master planning processes and for those utilised by AA themselves for the master plan's noise forecast charts.⁵⁰

6.1.4 ACCC's views on activity forecasts

The ACCC welcomes Airservices engagement of IATA to derive activity forecasts for its draft price notification, which is consistent with its 2004-05 LTPA. Indeed, the ACCC notes stakeholders' general support for the international activity forecasts put forward by Airservices. However, the ACCC also noted that a number of domestic and regional stakeholders expressed concerns that those forecasts are too low and do not reflect the growth in activity in recent years as well as that expected over the period covered by the draft price notification. In particular, Gold Coast Airport raised concerns that Airservices had under-estimated the growth in activity at its airport.

Airservices' general approach in determining activity forecasts for its draft price notification was based on aggregate activity forecasts across its network. However, Airservices stated that, following consultation with stakeholders, the estimated domestic traffic levels at Gold Coast and Cairns airports in 2011 were revised upwards to reflect recent strength in demand at those airports. Subsequent years' growth estimates remained in line with IATA's forecasts. The revised figures were included in appendix 1 to Airservices' draft price notification and are shown in table 6.1.

Table 6.3: Airservices' adjusted activity forecast growth for Cairns and Gold Coast airports (per cent)

Airport	Year	IATA's forecast growth	Airservices' adjusted forecast growth
Cairns Airport – MTOW	2011	3.9	14.5

⁵⁰ Gold Coast Airport, *ACCC Airservices Australia draft price notification issues paper*, 25 May 2011, pp. 4-5.

Airport	Year	IATA's forecast growth	Airservices' adjusted forecast growth
Gold Coast Airport – MTOW	2011	1.1	9.4

Source: Airservices Australia, *Draft price notification*, March 2011, p. 72.

The ACCC acknowledges Airservices' revision of the 2011 activity forecasts at Cairns and Gold Coast airports and considers that this is appropriate based on the stakeholders' feedback and the level of certainty surrounding the figures given that they were being estimated part way during the relevant period.

However, in relation to estimated future growth which naturally has a lower level of certainty, the ACCC considers that Airservices' general approach to developing activity forecasts in consultation with IATA is consistent with its 2004-05 LTPA and, therefore, is considered reasonable. The ACCC notes that the activity risk-sharing arrangements embodied within Airservices' draft price notification provide a trigger mechanism for review of pricing if activity forecasts are significantly different from actual levels (see section 5.2). Nevertheless, the ACCC also remains of the view that Airservices should continue to consider whether alternative risk-sharing arrangements would be appropriate for some individual airports as expressed in its 2004-05 decision.

7 Building-block model

As previously discussed, the ACCC uses the building-block model to assess the revenue required for the provision of an efficient service, giving consideration to the need for the regulated firm to earn a reasonable rate of return. Forecast activity levels are then used to translate required revenue levels into individual prices

Table 7.1 sets out Airservices' proposed building-block components, together with a summary of the relative contribution towards the required revenue.

Table 7.1: Airservices' proposed building-blocks (\$million) and proportion of required revenue (per cent)

Building-block component	2011-12	2012-13	2013-14	2014-15	2015-16	Total	% of revenue
Operating costs	671	702	732	762	794	3 662	75.9%
Depreciation	89	102	116	120	128	555	11.5%
Return on assets	92	102	110	117	123	544	11.3%
Tax allowance	10	12	12	13	14	61	1.3%
Required revenue	862	917	970	1 013	1 060	4 822	100.0%

Source: Airservices Australia, *Draft price notification*, March 2011, p. 29.

As illustrated in table 7.1, operating costs are the major component of Airservices' business, accounting for 75.9 per cent of its proposed required revenue. In contrast, return on capital (depreciation) and return on assets contribute 11.5 per cent and 11.3 per cent respectively to Airservices' proposed required revenue. Therefore, relatively small changes in Airservices' depreciation and return on assets are unlikely to have a significant impact on its required revenue and, ultimately, the end prices for its services.

In assessing Airservices' proposed building-blocks, the ACCC balances Airservices' need to generate a reasonable rate of return while at the same time promoting the efficient provision of services.

The remainder of this section examines the level of each of Airservices' proposed building-block components. This includes an assessment of Airservices':

- Operating costs (section 7.1)
- Opening asset base (section 7.2)
- Capital expenditure (section 7.3)
- Return of capital (depreciation) (section 7.4)
- Return on capital (section 7.5).

The ACCC's views on each of these components also takes into consideration its views on Airservices' risks and incentives for efficiency, which were discussed in section 5 of this document.

7.1 Operating costs

Operating costs play an important role in determining the required revenue in the building-block model. This is particularly true for Airservices, which has a relatively higher level of operating costs compared to capital costs contributing to its required revenue. Airservices' high level of operating costs arises because of its mix of capital-intensive infrastructure assets (such as TN towers) and the labour-intensive services required for the safe use of many of those assets (such as air traffic controllers).

As a result, the efficiency with which Airservices incurs its operating costs is a key consideration for the ACCC in its assessment of Airservices' draft price notification.

Although Airservices' draft price notification included depreciation in its discussion of operating costs, the ACCC notes that depreciation is determined by the interaction between the asset value and the life of the asset. As such, the ACCC has separately discussed depreciation in section 7.4 of this preliminary view, which immediately follows the discussion of asset values.

7.1.1 ACCC's previous decisions on operating costs

In its assessment of Airservices' 2004-05 LTPA, the ACCC noted its concern with the lack of formal efficiency targets and incentive mechanisms that would encourage it to

reduce costs, and considered that Airservices could further develop this aspect of its pricing in future proposals.

7.1.2 Airservices' position on operating costs

Airservices' estimated operating costs, as set out in its draft price notification, were split into two categories: staff costs and supplier costs. Airservices estimated that its total operating costs will increase by 18.3 per cent over the five years of its proposal, from \$671 million in 2011-12 to \$794 million in 2015-16. It stated that this reflected the required level of en route, TN and ARFF services associated with its forecast activity levels over that period.⁵¹

Tables 7.2 below sets out Airservices' estimated operating cost components, together with the average relative contribution towards total operating costs, while table 7.3 sets out the growth in estimated costs.

Table 7.2: Airservices' estimated operating costs (\$million) and proportion of total operating costs (per cent) over the five years

Operating cost component	2011-12	2012-13	2013-14	2014-15	2015-16	Total	% of costs
Staff costs	512	535	562	587	607	2 803	76.5%
Supplier costs	159	167	171	175	187	859	23.6%
Total staff and supplier costs	671	702	732	762	794	3 662	100.0%

Source: Airservices Australia, *Draft price notification*, March 2011, p. 29.

Table 7.3: Growth in Airservices' estimated operating costs over the five years (per cent)

Operating cost component	2011-12 to 2012-13	2012-13 to 2013-14	2013-14 to 2014-15	2014-15 to 2015-16	5-year change	Average annual change
Staff cost growth	4.5%	5.1%	4.5%	3.4%	18.6%	4.4%
Supplier cost growth	5.0%	2.4%	2.4%	6.9%	17.6%	4.1%
Total staff and supplier cost growth	4.6%	4.3%	4.1%	4.2%	18.3%	4.3%

As illustrated in tables 7.2 and 7.3, Airservices estimated that staff and supplier costs would, on average, grow by approximately 4.4 per cent and 4.1 per cent annually over the five years of its proposal.

Airservices stated that, since its 2004-05 price notification, its operating cost base had increased by around \$110 million. Airservices stated that this was largely because:

⁵¹ Airservices Australia, *Draft price notification*, March 2011, p. 29.

- pay increases occurred at the rate of around 4.2 per cent per annum (totalling \$71 million);
- there was a significant increase in the training amenity and recruits required to cater for a rapidly ageing workforce;
- five new ARFF and air traffic control services were introduced;
- regulatory changes increased air traffic control service requirements at General Aviation Aerodrome Procedures (GAAP) aerodromes; and
- investment in key infrastructure increased to support industry growth.⁵²

Airservices also stated that a number of further cost base changes had occurred more recently, or were projected to occur over the five years of its proposal. In particular:

- new TN services at Broome and Karratha
- new ARFF services at two regional locations (such as Ballina, Coffs Harbour or Port Headland due to increased traffic)
- ARFF service category ten upgrades for Brisbane and Perth
- continued investment growth and associated impact on depreciation
- further regulatory changes including the provision of approach services into current Class D regional tower locations.⁵³

Airservices noted, however, that it has not included costs associated with additional superannuation contributions that support the retirement incomes of current and past employees in its draft price notification. Such costs would normally be passed through as part of Airservices' normal labour cost.⁵⁴

As discussed in section 5 of this paper, Airservices also provided the ACCC with information on its governance and processes for efficiency to support its claim that it is efficiently incurring operating costs.

7.1.3 Views of interested parties on operating costs

The ACCC's issues paper sought comments from interested parties on the efficiency with which Airservices provides its services. In particular, the ACCC sought comments on the level of Airservices' estimated operating costs, its incentives for, and effectiveness in, containing and reducing its operating costs and the efficiency with which Airservices conducts its recruitment and training. The ACCC also sought stakeholders' views on whether Airservices had adequately addressed the ACCC's views on its efficiency targets.

⁵² Airservices Australia, *Draft price notification*, March 2011, p. 30.

⁵³ Airservices Australia, *Draft price notification*, March 2011, p. 30.

⁵⁴ Airservices Australia, *Draft price notification*, March 2011, p. 10.

In general, interested parties submitted that there was insufficient information to comment on the efficiency with which Airservices provides its services.

AOPA noted that it 'accepts the draft price notification and is satisfied with the consultation that preceded it'.

RAAA stated that Airservices' operating costs appear to reflect the costs that Airservices would incur over the five year period. In relation to recruitment and training, RAAA submitted that Airservices 'operates in a constrained market place for people'.⁵⁵

Air New Zealand stated that 'it is not clear whether Airservices, in forecasting a significant increase in costs over the five year period, has adopted a properly robust approach'.⁵⁶

Cathay Pacific Airways submitted that it could not assess Airservices' comparative efficiency because the benchmark comparisons provided by Airservices were not comparable. Cathay Pacific Airways stated that a more rigorous benchmarking methodology is required.

IATA stated that it does not believe that the current operating costs proposals represent any efficiency improvement and that Airservices should keep its operating costs constant (in nominal terms) throughout the period. In particular, IATA noted that Airservices' draft price notification did not provide evidence on how efficient it is with respect to comparable service providers. Further, IATA submits that Airservices has not made any efforts to address the ACCC's requests for an appropriate benchmarking tool.⁵⁷

United Continental Holdings stated its support of IATA's comments.

BARA submitted that it was not in a position to comment on Airservices' estimated operating costs as a result of Airservices' lack of transparency over its costs and formal efficiency targets. BARA stated that it was 'disappointed [Airservices] has devoted little time or resources to justifying its operating costs'.⁵⁸

VAA also submitted that Airservices had not provided sufficient transparency over its operating costs.

Qantas Group raised concerns that Airservices' 'consultation process has not provided sufficient clarity on the operation costs of [Airservices]' and, as a result, it is unable to make informed comment with respect to the evidence of efficiency or to benchmark operational costs. Although Qantas Group did note that it is supportive of the progress that has been made towards driving appropriate behaviours within the organisation, it

⁵⁵ Regional Aviation Association of Australia, *ACCC Airservices Australia draft price notification issues paper*, 11 May 2011, p. 4.

⁵⁶ Air New Zealand, *Airservices Australia draft price notification*, 13 May 2011, p. 2.

⁵⁷ International Air Transport Association, *IATA submission to the ACCC issues paper on Airservices Australia's draft price notification*, 10 May 2011, pp. 6-7.

⁵⁸ Board of Airline Representatives of Australia Inc., *Response to ACCC Airservices Australia draft price notification issues paper*, May 2011, p. 11.

noted that there are no clear efficiency targets or mechanisms to penalise Airservices if targets are not achieved.⁵⁹

7.1.4 ACCC's views on operating costs

Airservices' draft price notification identified a \$110 million (20 per cent) increase in operating costs in the first year of its proposal compared to the 2008-09 figure assessed in its 2004-05 LTPA. Further, Airservices forecasted operating expenses to increase by 18.3 per cent over the five years of its proposal, with an average annual increase of 4.3 per cent.

The ACCC notes that the majority of submissions said that there was insufficient information to comment on the efficiency with which Airservices provides its services. Further, with the exception of RAAA who submitted that level of operating costs appeared reasonable, submissions did not provide direct comment on the level of estimated operating costs. Further, the ACCC notes concerns raised in section 5 about the strength of processes that provide Airservices with an incentive to operate efficiently.

Therefore, the ACCC has sought additional information to provide it with some indication about the efficiency of Airservices' proposed operating costs. In particular, given that staff costs represent the most significant proportion of the increase in Airservices' operating costs, the ACCC has sought information on increases in staff salaries and numbers over the five years of the proposal. The ACCC's consideration of these matters is outlined below.

Increase in Airservices' staff salaries over the five years of its proposal

As illustrated in table 7.2, staff costs are the major component of Airservices' operating costs, contributing 76.5 per cent to its total operating costs over the five years of its proposal. Therefore, in assessing Airservices' proposed operating costs, the ACCC has considered it important to understand the main drivers behind the increases in staff costs.

There are a number of factors that affect Airservices' staff costs over the five years of its proposal, including existing salary levels, allowances for increases in salaries, increases in staff and associated increases in staff oncosts.

Eighty per cent of Airservices' workforce is comprised of operational staff who work in the ATC, ARFF and technology and asset services (TAS) groups. The non-operational staff (20 per cent of Airservices' workforce) provide safety, training and corporate services.⁶⁰

⁵⁹ Qantas Group, *Submission to ACCC issues paper on Airservices Australia's five year draft pricing proposal*, 11 May 2011, p. 7.

⁶⁰ Airservices Australia, *Workforce plan 2010-2013*, May 2010, p. 7.

The annual salaries for ATC staff currently ranges from \$59,702 for a field trainee, \$167,222 for a unit tower supervisor, and up to \$179,991 for a SY CSS/supervisor.⁶¹ As discussed in section 5.6, Airservices confidentially provided the ACCC with international benchmarking studies of its ATC services. This information does not suggest that Airservices' existing salary levels for ATC are excessive when compared with those in Canada, New Zealand and South Africa, which Airservices advised were likely to be the relevant benchmarks.

Airservices' collective agreement for 2009-12 provides for a pay increase for ATC staff of 3 per cent on 1 September 2011 and 3.1 per cent on 1 March 2012. Airservices also confidentially provided the ACCC with estimated increases in ATC staff salaries over the five years of its proposal. The ACCC has assessed these increases and does not consider them to be unreasonable on the basis that they are comparable to Airservices' historical increases as well as increases provided for in recent collective agreements within the airport and airline industries.

The annual salaries for ARFF staff currently ranges from \$27,230 for a recruit fire fighter, \$68,668 for a leading fire fighter, and up to \$84,641 for a fire commander.⁶² International benchmarking studies provided to the ACCC did not include ARFF services. However, the ACCC notes that the salaries for Australian metropolitan fire and emergency services staff currently range from \$41,685 for a recruit fire fighter, \$74,851 for a leading fire fighter, and up to \$110,124 for a fire commander (after 24 months).⁶³ This information does not suggest that Airservices' existing salary levels for ARFF staff are excessive.

Airservices' collective agreement for 2009-13 provides for a pay increase for ARFF staff of 2.15 per cent every six months up until 2013. Airservices also confidentially provided the ACCC with estimated increases in ARFF staff salaries over the five years of its proposal. The ACCC has assessed these increases and does not consider them to be unreasonable on the basis that they are comparable to Airservices' historical increases.

In relation to TAS staff and non-operational staff, Airservices' collective agreement for 2009-13 provides for a pay increase of 2.15 per cent every six months up until 2013. Airservices also confidentially provided the ACCC with estimated increases in these staff salaries over the five years of its proposal. The ACCC has assessed these increases and does not consider them to be unreasonable on the basis that they are comparable to Airservices' historical increases as well as increases provided for in more recent collective agreements within relevant similar industries.

The ACCC would need to be provided with more detailed benchmarking information than was available in order to make a more detailed assessment of whether or not Airservices is operating at efficient levels. Further, as discussed in section 5, the ACCC considers that Airservices has scope to improve its incentives for efficiency.

⁶¹ Airservices Australia, *Air traffic control and supporting air traffic control collective agreement 2009-2012*, p. 74.

⁶² Airservices Australia, *Aviation rescue fire fighting collective agreement 2009-2013*, p. 71.

⁶³ Metropolitan Fire and Emergency Services Board, *Metropolitan fire and emergency services board operational staff agreement 2010*, p. 95.

Nevertheless, on the basis that the available benchmarking information in relation to staff costs does not raise concerns, the ACCC has formed the view that Airservices' existing salary levels and estimated increases in salaries appear reasonable.

Increase in staff numbers over the five years of its proposal

Airservices' annual report for 2009-10 provides that, as at 30 June 2010, Airservices had a total of 3,485 permanent staff. This is comprised of approximately 34 per cent ATC staff, 20 per cent ARFF staff and 25 per cent TAS staff. The remaining 19 per cent are non-operational staff.⁶⁴

Airservices' draft price notification estimated that some additional staff would be required to support new and increased service levels throughout the five years of its proposal. Further, increases in recruitment and training would be needed to cater for a rapidly ageing workforce.

Airservices' workforce plan for 2009-13 provides the following staff forecasts:

- ATC staff numbers required will remain relatively stable across the planning period. However, close to 100 ATC trainees will be recruited annually in order to offset the impact of retirements and resignations. The plan notes that, by ensuring that the supply of ATC staff is greater than required, this will reduce the high dependency on overtime.
- ARFF staff numbers will increase across the planning period as a result of new and increased services. Airservices forecasted that approximately 100 additional ARFF staff would be required by 2013—equivalent to a growth of 13 per cent.
- TAS staff numbers will increase across the planning period as a result of Airservices' increased capital expenditure program. Airservices forecasted that approximately 95 additional TAS staff would be required by 2013—equivalent to a growth of 11 per cent.
- Non-operational staff numbers will remain relatively stable across the planning period.

Airservices also confidentially provided the ACCC with forecast changes in staff numbers over the five years of its proposal. The ACCC has assessed these and does not consider them to be unreasonable on the basis that the increases reflect the required number of staff for providing the projected level of new and increased services and delivering on the capital expenditure program over the period.

Summary

The ACCC has assessed the level of Airservices' staff costs using benchmarking studies and comparisons, where available. These indicate that the levels of costs do not appear to be unreasonably high. The ACCC notes that increases in supplier costs relate to new or increased levels of service and capital expenditure.

⁶⁴ Airservices Australia, *Annual report 2009-2010*, October 2010, p. 10.

Benchmarks of cost efficiency are not, however, readily available. To this end, the ACCC notes that Airservices' commitment to improving its formal efficiency targets and KPIs (as discussed in section 5) will provide incentives for Airservices to operate efficiently and ensure that its operating costs do not increase beyond reasonable levels in future periods.

On this basis, the ACCC is prepared to accept the proposed level of operating costs in Airservices draft price notification.

7.2 Opening asset base

In the building-block model, the initial valuation of the asset base is an important element in determining the required revenue. In particular, the value of assets is fundamental to the calculation of both the return of capital (depreciation) and return on capital used in the required revenue calculations.

7.2.1 ACCC's previous decisions on opening asset base

In its 2004-05 decision, the ACCC stated that the value of Airservices' asset base contained in the 2004-05 LTPA could be used as a reference point for future price notifications, taking into account new and efficient investment. The opening value of assets in the 2004-05 LTPA was \$338 million.

The ACCC also stated that it would expect Airservices to provide the necessary information covering the past five years as well as projections for future periods in future long-term pricing agreements.

7.2.2 Airservices' position on opening asset base

In its draft price notification, Airservices proposed an opening asset base of \$865 million. Airservices stated that the opening value of assets was based on the values assessed by the ACCC in 2004-05, or at cost for assets added post-2004, less depreciation.⁶⁵

In addition to the information contained in its draft price notification, Airservices provided the ACCC with a summary of its asset value movements between 2004-05 and 2010-11, which is reproduced in table 7.4. Airservices also confidentially provided the ACCC with a list of the significant capital expenditure projects that were undertaken during the period and details of the useful lives applied to assets for the purposes of calculating depreciation.

⁶⁵ Airservices Australia, *Draft price notification*, March 2011, p. 31.

Table 7.4: Airservices’ asset value movements between 2004 and 2011 (\$million)

	Actual assets 01/07/2005 – 30/06/2009	Actual assets 01/07/2009 – 30/06/2011	Proposed asset base as at 30/06/2011
Existing assets as per original valuation (30/09/2004)	338		
Capital expenditure and work in progress 2003-04	99		
Total assets as at 01/07/2005	437		
Capital expenditure 2005-2009	567		
Capital expenditure 2009-2011		356	
Depreciation 2005-2011	(462)	(33)	
Total assets as at 30/06/2011	542	323	865

Source: Airservices Australia, *Response to ACCC’s additional information request*, 17 May 2011, p. 7.

Airservices stated that, over the last five years, the majority of its investment had targeted asset renewals as a large part of its asset base was approaching the end of its life.⁶⁶ Airservices also noted that some of the growth in its asset base was a result of actual capital expenditure and, therefore, depreciation, differing from its projected amount as per its 2004-05 price notification.

For example, in its 2004-05 price notification, Airservices projected cost for the Melbourne Airport control tower was \$7.2 million with annual depreciation of \$207,455. However, the actual cost for the control tower was \$15.5 million with annual depreciation of \$773,750. This resulted in an additional capital expenditure of \$8.3 million and additional annual depreciation of \$566,295.⁶⁷

7.2.3 Views of interested parties on opening asset base

The ACCC’s issues paper sought comment from interested parties on the appropriateness of the opening value of Airservices’ asset base. In particular, comment was invited on whether Airservices had demonstrated that the opening asset base could be reconciled with the asset base in its 2004-05 price notification. Also, comment was sought on whether Airservices had provided sufficient information regarding which capital projects had driven the change in the asset values between 2004-05 and 2010-11.

Interested parties expressed mixed opinions about the appropriateness Airservices’ proposed opening asset base. Some parties accepted Airservices’ proposal, while others

⁶⁶ Airservices Australia, *Draft price notification*, March 2011, p. 31.

⁶⁷ Airservices Australia, *Response to ACCC’s additional information request*, 17 May 2011, p. 7.

submitted that Airservices had provided them with insufficient information to determine the appropriateness of the opening asset base and raised concerns that it could be overstated.

RAAA stated that the opening asset base appeared to reflect the 2004 base carried forward and the projects which have driven the base since 2004.

VAA noted that a significant percentage of Airservices' capital expenditure since 2004 was devoted to upgrading aging infrastructure. However, VAA submitted that it was more concerned with the way in which Airservices' capital expenditure had been procured, namely through various ad hoc approaches to the market.⁶⁸

IATA raised concerns that Airservices' proposed opening asset base might be overestimated, submitting that:

Despite numerous requests, [Airservices] has not provided an adequate, year-by-year, reconciliation between the proposed opening asset base and the asset base used in the 2004 long-term pricing agreement.

IATA's concerns are based on the fact that the opening asset base for this period might be overestimated. This is due to potential differing depreciation allowances when rolling forward the asset base.⁶⁹

IATA also noted its concern about a lack of regulatory accounts, submitting that Airservices should be required to prepare and provide such accounts on a yearly basis.

BARA stated that it was not in a position to provide meaningful comment on Airservices' proposed opening asset base due to insufficient information. In particular:

BARA had expected Airservices would provide a detailed overview of how its expenditures and revenues were tracking against that forecast in 2004 ... if this had occurred, then BARA would be in a position to comment on Airservices' calculated opening asset base.⁷⁰

Further, BARA submitted that Airservices' 'asset management process contains a number of systematic deficiencies as substantial problems with existing assets are being identified'.⁷¹

The Qantas Group submitted that there was insufficient information and it was not clear which assets and projects had driven the change in asset values since 2004. In particular, Qantas Group stated that 'only high level figures were presented and since charges were held over for 2 years from 2009 [there was] not sufficient detail available to assess these matters'.⁷²

⁶⁸ Virgin Australia Airlines, *Response to the ACCC Airservices Australia draft price notification issues paper*, 10 May 2011, p. 9.

⁶⁹ International Air Transport Association, *IATA submission in response to the ACCC issues paper on Airservices Australia's draft price notification*, 10 May 2011, p. 7.

⁷⁰ Board of Airline Representatives of Australia Inc., *Response to the ACCC Airservices Australia draft price notification issues paper*, May 2011, pp. 11-12.

⁷¹ *ibid.*, p. 12.

⁷² Qantas Group, *Submission to ACCC issues paper on Airservices Australia's five year draft pricing proposal*, 11 May 2011, p. 7.

7.2.4 ACCC's views on opening asset base

The ACCC endorses Airservices' approach to establishing its opening value of assets based on the values assessed in its 2004-05 LTPA, taking into account new investment based on actual costs and associated depreciation. This is consistent with the ACCC's previous decisions on the opening asset base as discussed in section 7.2.1.

However, the also ACCC notes concerns raised by stakeholders regarding the level of transparency provided by Airservices in rolling forward its asset base from its 2004-05 LTPA and, therefore, concerns that the opening value of assets could be overstated. As noted in section 7.2.1, the ACCC expected that Airservices would provide the necessary information covering the past years as well as projections for future periods in this LTPA. The ACCC acknowledges that Airservices' draft price notification provided very limited information in this respect and expects that Airservices provide greater detail in future price notifications. This is discussed further below.

Therefore, in seeking to understand the main drivers behind the asset value movements since its 2004-05 LTPA, the ACCC requested that Airservices provide a summary of its asset value movements (shown in table 7.4 above). Airservices was also asked to provide a list of the significant individual capital expenditure projects that were undertaken during the period.

In considering the information, the ACCC had regard to Airservices' comments that it had included new assets at cost, less depreciation. In particular, Airservices stated that it does not include any asset revaluations that have been recognised as part of normal statutory financial reporting as a result of indexation or re-lifing.⁷³ Airservices stated that this means accounting adjustments for asset revaluations (particularly upward land and building revaluations due to market indexation) are not passed on in charges. Airservices confidentially provided the ACCC with information to demonstrate that new assets are included in its asset base at cost.

The ACCC has reviewed this information and is satisfied that Airservices has not included asset revaluations in its asset base for the purpose of calculating its opening value of assets. The ACCC considers that this approach is consistent with the approach it envisaged in its assessment of the 2004-05 LTPA. The ACCC is also satisfied that the movement in the value of assets represents costs that have been incurred by Airservices. On this basis, the ACCC is prepared to accept the level of capital expenditure that Airservices' has used in rolling forward its asset base.

As a final point, the ACCC acknowledges concerns raised regarding the useful lives applied to assets for the purposes of calculating depreciation. This is discussed in greater detail in the discussion of return of capital (depreciation) (section 7.4). As noted in that section, the ACCC does not have concerns with the useful lives applied by Airservices for the purposes of calculating depreciation and, therefore, rolling forward its asset base.

⁷³ Airservices Australia, *Draft price notification*, March 2011, p. 31.

In summary, the ACCC is prepared to accept Airservices' proposed opening value of assets of \$865 million. However, the ACCC expects that Airservices will provide a detailed reconciliation of its proposed opening value of assets in future LTPAs. In particular, the ACCC expects that Airservices will be able to demonstrate how actual capital expenditure (and associated depreciation) compares to that projected in this LTPA. For example, Airservices would be expected to provide a summary of the actual costs incurred over the period compared to those projected in this LTPA for all individual projects greater than \$10 million. This is also discussed in section 5.

The ACCC also notes that the ability of Airservices to demonstrate its actual costs incurred does not provide it with an automatic right to include it in the rolling forward of its asset base for future LTPAs. The ACCC will also need to be satisfied that those costs have been incurred prudently and efficiently, which is relevant to its discussion of Airservices' consultation processes in section 5.5.

7.3 Capital expenditure

The value of assets is fundamental to the calculation of both the return on capital and depreciation used in the required revenue calculations. Therefore, it is important that the ACCC ensures that capital expenditure is undertaken prudently and efficiently.

7.3.1 ACCC's previous decisions on capital expenditure

In its 2004-05 assessment, the ACCC recognised that Airservices' capital expenditure had been developed in consultation with industry and that it had in place reasonable administrative processes to internally assess capital expenditure projects.

However, the ACCC encouraged Airservices to increase the transparency and analytical rigour of its decision making in relation to its choice of capital expenditure projects. The ACCC noted that this should include the provision of adequate information to stakeholders who suggest alternative solutions to capital expenditure or who question aspects of Airservices' capital program. Further, the ACCC considered it important for Airservices to detail the consultative and decision-making processes relating to its capital expenditure program.

7.3.2 Airservices' position on capital expenditure

Airservices proposed a capital investment program with expenditure of approximately \$958 million over the five-year period covered by its draft price notification. This compares to Airservices' capital expenditure of \$923 million between 2004-05 and 2010-11. A summary of Airservices' proposed capital expenditure is contained in its draft price notification and has been reproduced in table 7.5 below.

Table 7.5: Summary of Airservices' proposed capital expenditure (\$million)

	2011-12	2012-13	2013-14	2014-15	2015-16
Opening asset balance	865	981	1 066	1 144	1 209
Capital expenditure	205	186	193	186	185
Depreciation	89	102	116	120	128
Closing asset balance	981	1 066	1 144	1 209	1 266

Source: Airservices Australia, *Draft price notification*, March 2011, p. 31.

7.3.3 Views of interested parties on capital expenditure

The views of interested parties on Airservices' proposed level of capital expenditure was discussed in section 5 of this document. A number of stakeholders submitted that they were satisfied with Airservices' consultation processes on capital expenditure but not necessarily the outcomes of those processes. While a number of submissions raised concerns about Airservices' timing, extent of consultation and accountability for delivering on agreed projects. Further, a number of stakeholders called for the removal of certain projects from the LTPA.

7.3.4 ACCC's views on capital expenditure

The ACCC notes that the proposed capital investment program is sizeable, and is the principal driver of Airservices' proposed price increases over the five-year period. Therefore, the ACCC requires assurance that Airservices' proposed capital projects are appropriate and represent an efficient allocation of resources. The ACCC also requires assurance that Airservices is accountable for the delivery of projects.

In section 5 of this document, the ACCC has raised some concerns about the strength of processes that provide Airservices with an incentive to undertake prudent and efficient investment, as well as its level of accountability for delivering on agreed capital expenditure projects. In particular, the ACCC has noted concerns relating to:

- timeliness and level of information provided in consultation processes with stakeholders (section 5.5)
- reporting to stakeholders on the delivery of the capital expenditure program on a project-by-project basis (section 5.2 and 5.5)
- strength of the Charter to monitor and provide a measurement of performance (section 5.3)

In the ACCC's view, Airservices needs to commit to addressing the concerns raised in those sections prior to it submitting its formal price notification. If Airservices can address these matters, the ACCC would be minded to accept Airservices' proposed level of capital expenditure.

7.4 Return of capital (depreciation)

The return of capital (depreciation) on an asset is determined by the interaction between the asset value and the life of the asset. The above discussions regarding the opening asset base (section 7.2) and capital expenditure (section 7.3) therefore has implications for determining the appropriate return of capital.

7.4.1 ACCC's previous decisions on return of capital

The ACCC reviewed the recovery capital expenditure through depreciation in its assessment of Airservices' 2004-05 LTPA and concluded that depreciation was based on the economic useful lives of assets.

7.4.2 Airservices' position on return of capital

Airservices proposed a return of capital of approximately \$555 million over the five-year period covered by its draft price notification. Tables 7.6 below sets out Airservices' proposed return of capital, together with the annual and total growth costs.

Table 7.6: Airservices' proposed return of capital (\$million) and growth in return of capital (per cent) over the five years

	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Depreciation	89	102	116	120	128	555
Depreciation cost growth		14.7%	13.7%	4.1%	6.6%	44.7%

Source: Airservices Australia, *Draft price notification*, March 2011, p. 31.

Airservices stated that the level of depreciation is based on the estimated useful life of both existing and new assets acquired through the capital expenditure program. Airservices also confidentially provided the ACCC with information regarding the useful life assets it applied for the purposes of calculating depreciation.

7.4.3 Views of interested parties on return of capital

Some stakeholders raised concerns about the useful lives of assets applied by Airservices for the purposes of calculating depreciation.

For example, IATA raised concerns that Airservices' proposed opening asset base might be overestimated, submitting that:

Despite numerous requests, [Airservices] has not provided an adequate, year-by-year, reconciliation between the proposed opening asset base and the asset base used in the 2004 long-term pricing agreement.

IATA's concerns are based on the fact that the opening asset base for this period might be over estimated. This is due to potential differing depreciation allowances when rolling forward the asset base.⁷⁴

7.4.4 ACCC's views on return of capital

As discussed above, in its assessment of Airservices 2004-05 LTPA, the ACCC concluded that depreciation was based on the economic useful lives of assets.

The ACCC notes the concerns raised by some stakeholders about the useful lives of assets that Airservices appears to have applied for the purposes of calculating depreciation. Airservices has, on a confidential basis, provided the ACCC with a detailed list of the useful lives applied to assets for the purposes of calculating depreciation. The ACCC has reviewed this information and has not found any areas of concern on the basis that the application is consistent with Airservices' 2004-05 LTPA.

On this basis, the ACCC is prepared to accept the useful lives applied by Airservices in its draft price notification for the purposes of calculating depreciation. Although, the ACCC notes that any adjustment made to the level of capital expenditure when Airservices submits its formal price notification should also be reflected in an associated adjustment to the level of return of capital.

7.5 Rate of return on capital

The return on capital is a component of the building block model that ensures that both debt and equity holders receive a rate of return that reflects the opportunity cost of capital invested in the business. It should be commensurate with the risks associated with the firm's operations.

In calculating the required rate of return, the building block model estimates a number of parameters to determine both the cost of debt and cost of equity capital. It then weights these costs in accordance with the firm's capital structure to determine the weighted average cost of capital (WACC). That is:

$$\text{WACC} = R_d(D/V) + R_e(E/V)$$

Where:

- R_d is the cost of debt;
- R_e is the cost of equity;
- D is the market value of debt;
- E is the market value of equity; and
- V is the market value of total assets.

The WACC is then applied to the regulated asset base to estimate the required return on capital for the period.

⁷⁴ International Air Transport Association, *IATA submission in response to the ACCC issues paper on Airservices Australia's draft price notification*, 10 May 2011, p. 7.

7.5.1 ACCC's previous decisions on rate of return on capital

In its 2004-05 decision, the ACCC considered that an asset beta of 0.55 was appropriate for Airservices given the level of risk associated with its operations. Given the relationship between the asset and equity betas and the nature of Airservices' operations, the ACCC was of the view that the resulting equity beta of 1.0 was appropriate. The ACCC also considered that the adoption of a gearing ratio of 45 per cent was acceptable.

In estimating the cost of debt margin, the ACCC accepted a benchmark credit rating of AAA. Finally, in assessing the risk-free rate, the ACCC calculated a ten-day moving average of the nominal risk-free rate just prior to releasing its decision.

The WACC parameters accepted by the ACCC in its 2004-05 decision are outlined in table 7.7 below.

7.5.2 Airservices' position on rate of return on capital

Airservices proposed a 'nominal vanilla WACC' of 9.95 per cent. Airservices stated that this is based on the WACC parameters assessed by the ACCC in 2004-05, with some adjustments made by Airservices to the nominal risk free rate and the cost of debt margin. Table 7.7 summarises the WACC parameters proposed by Airservices.

Table 7.7: Airservices' proposed WACC parameters

Measure	ACCC's 2004-05 decision	Airservices' 2011-12 proposed
Nominal risk free rate (R_f)	5.41%	5.58%
Debt margin (d_m)	0.55%	2.37%
Market risk premium ($R_m - R_f$)	6.00%	6.00%
Corporate tax rate (T_c)	30.00%	30.00%
Dividend imputation (γ)	50.00%	50.00%
Gearing ratio (D/V)	45.00%	45.00%
Asset beta (β_a)	0.55	0.55
Debt beta (β_d)	0.00	0.00
Equity beta (β_e)	1.00	1.00
Cost of debt (R_d)	5.96%	7.95%
Cost of equity (post tax nom) (R_e)	11.39%	11.58%
Nominal vanilla WACC	8.95%	9.95%

Source: Airservices Australia, *Draft price notification*, March 2011, p. 32.

Airservices stated that the nominal risk free rate applies a 40-day average to 21 February 2011 of a current ten-year government bond rate and results in an increase of 0.17 per cent from the rate used in the ACCC's 2004-05 decision.

In relation to the cost of debt margin, Airservices stated that:

Regulatory practice in Australia has been to use fair value estimates from sources such as Bloomberg and CBASpectrum to estimate the debt margin. This task has become more difficult since CBASpectrum ceased reporting fair value estimates in 2010, and Bloomberg has steadily reduced the number of long-dated fair values estimates that it provides.

The most recent ten year corporate fair value estimate provided by Bloomberg was for AAA rated bonds on 22 June 2010. The increase in debt margin between five and ten years to maturity for that fair value curve was 0.67 per cent. Airservices' current 'stand-alone' credit rating is AA and the current ten year AA debt margin is estimated by adding this to the current five year AA debt margin giving an estimate of 2.37 per cent.

Airservices submitted that the procedure it uses for estimating the debt margin is consistent with the procedure used by the Australian Energy Regulator (AER) in its most recent decision to extrapolate forward the Bloomberg BBB fair value curve.⁷⁵

Airservices also confidentially provided the ACCC with a report by Pricewaterhouse Coopers (PwC) in support of its approach to determining its proposed WACC parameters.

7.5.3 Views of interested parties on rate of return on capital

The ACCC sought comment from interested parties on the appropriateness of Airservices' proposed rate of return on capital. In particular, the ACCC sought comment on whether the proposed rate of return reflected an appropriate benchmark given the risks borne by Airservices.

In general, stakeholders commented that Airservices' proposed rate of return was either reasonable or too high given the risks borne by Airservices.

RAAA stated that it was 'content with the proposed rate of return used by [Airservices]'.⁷⁶

BARA also submitted that it 'does not object to [Airservices'] proposed WACC parameters'. However, BARA 'proposes that [Airservices] accepts a lower rate of return on its assets to fund the current cross subsidies to domestic and GA airfields'.⁷⁷

Air New Zealand stated that it 'considers that the rate of return being targeted by Airservices is overstated, given the risk profile of the business'.⁷⁸

REX also submitted that the rate of return appeared too high and that 'a return of around 2 per cent above that of an official industry rate is considered more reasonable'.⁷⁹

⁷⁵ Airservices Australia, *Draft price notification*, March 2011, p. 32.

⁷⁶ Regional Aviation Association of Australia, *ACCC Airservices Australia draft price notification issues paper*, 11 May 2011, p. 5.

⁷⁷ Board of Airline Representatives of Australia Inc., *Response to the ACCC Airservices Australia draft price notification issues paper*, May 2011, p. 13.

⁷⁸ Air New Zealand, *Airservices Australia draft price notification*, 13 May 2011, p. 2.

⁷⁹ Regional Express, *Regional Express submission to the ACCC*, May 2011, p. 8.

Qantas Group submitted that Airservices' debt margin and asset beta are too high. In particular, Qantas stated that:

The proposed [Airservices] debt margin of 237bp above the risk free rate is unacceptably high. It is based on a stand alone rating of AA and recent regulatory decisions for other unrelated industries such as Australia Post with contestable services. The previous ACCC decision for [Airservices] in 2004 was for AAA and 55bp, on this basis the debt margin should be reviewed. The Qantas Group strongly believes that a better proxy would be the Australian Government credit default swap pricing which is currently at around 40-50bp for five years.

The Qantas Group would also challenge on a similar basis that the asset Beta of 0.55 is too high. Airways NZ has set their asset beta at 0.45. The inherent risk of [Airservices] not recovering their revenue targets is low. Over the past 7 years activity growth has remained high despite the numerous shocks to the industry and the economy. Demand is closely linked to the available seat capacity and airlines use other levers to stimulate demand to keep their aircraft assets flying. It was also noted in the ACCC 09/10 price monitoring report that airlines buffer economic impacts to demand by reducing airfares. In the face of such evidence it is hard to see that AsA contains such a high level of risk, one that is higher than New Zealand with a significantly smaller population and economy.⁸⁰

IATA stated that the five-year government bond rate should be used as the risk-free rate instead of the ten-year rate, and that it does not support the debt premium as Airservices' credit rating is AAA. Further, IATA submitted that a higher gearing level should be used.⁸¹

VAA submitted that 'Airservices is not exposed to a high level of commercial and competitive risk being a government owned provider' and, therefore, VAA 'considers the debt margin used in the WACC calculation is too high'.⁸²

7.5.4 ACCC's views on rate of return on capital

The ACCC considers that Airservices' proposal to update the nominal risk-free rate is appropriate given the time elapsed since the ACCC's 2004-05 decision. Further, the ACCC is of the view that if the risk-free rate is to be re-examined then it is also appropriate that the cost of debt margin and the market risk premium (MRP) be re-assessed. The ACCC's assessment of Airservices' proposed values for these parameters is outlined further below.

In relation to the remaining WACC parameters, the ACCC is prepared to accept Airservices' approach to leave them unchanged from 2004-05. In particular, although the ACCC notes that some submissions raised concerns that the rate of return was too high given the risks borne by Airservices, the ACCC considers that there is unlikely to have been any significant change to Airservices' risks compared to 2004-05 (see section 7.5).

⁸⁰ Qantas Group, *Submission to ACCC issues paper on Airservices Australia's five year draft pricing proposal*, 11 May 2011, p. 9.

⁸¹ International Air Transport Association, *IATA submission in response to the ACCC issues paper on Airservices Australia's draft price notification*, 10 May 2011, pp. 10-11.

⁸² Virgin Australia, *Response to ACCC Airservices Australia draft price notification issues paper*, 10 May 2011, p. 11.

The ACCC notes that, when considered against other recent decisions, an asset beta of 0.55 and the equity beta of 1.0 that this implies appear to be high. The ACCC also notes the views of submissions that the beta appears to be high. However, in the context of this price notification, the ACCC is prepared to accept these figures on the basis that they are consistent with the ACCC's 2004-05 decision and, as discussed above, the risk to Airservices' operations appears to be relatively unchanged.

Nominal risk-free rate

The ACCC considers that the use of a five-year Government bond, averaged over a number of days to remove any short-term variability, is an appropriate estimation for the nominal risk-free rate. As with the ACCC's other recent decisions, the ACCC considers a 20-day averaging period, beginning as close as possible to the start of the regulatory period to best reflect market expectations, is appropriate.

In relation to the use of a five-year term, the ACCC notes that the regulatory practice regarding the term for estimating the nominal risk-free rate (and the cost of debt margin for that matter) is currently under review by a number of regulators, including the ACCC.⁸³ However, in the context of this current price notification, the ACCC considers that the use of a five-year rate is appropriate in these circumstances. This reflects the five-year period covered by Airservices' draft price notification and is consistent with the comments made by stakeholders in their submissions on the matter. Further, as discussed below, Airservices has relied on the use of a five-year term to estimate the cost of debt margin.

On this basis, the ACCC has estimated the nominal risk-free rate as at the time of writing to be 4.92 per cent.⁸⁴ This is lower than Airservices' estimated nominal risk-free rate of 5.58 per cent, which was based on a 40-day average (to 21 February 2011) of a ten-year Government bond.

When estimating the nominal risk-free rate for its formal price notification, the ACCC expects that Airservices will use a five-year Government bond, averaged over a 20-day period beginning as close as practicable to submitting to the ACCC.

Cost of debt margin

The ACCC notes that, in estimating its cost of debt margin, Airservices has applied an AA credit rating, which it states is its current 'stand-alone' credit rating. The ACCC recognises that Airservices is a wholly-owned Government entity. As noted above, the ACCC previously accepted a benchmark credit rating of AAA.

The ACCC considers that Airservices has not sufficiently substantiated why an AA credit rating should now be applied. Therefore, the ACCC considers that the most reasonable approach to determining an appropriate credit rating for Airservices is to use

⁸³ For example, the Independent Pricing and Regulatory Tribunal (IPART) released a final decision in April 2011 to apply a five-year term for market-based WACC parameters. See IPART, *Developing the approach to estimating the debt margin – final decision*, April 2011.

⁸⁴ In estimating the nominal risk-free, the ACCC used Bloomberg to obtain the most recent 20-day average of the yield to maturity for five-year Commonwealth Government securities.

the benchmark credit rating consistent with that used in the 2004-05 decision, which is AAA. As a check on the reasonableness of this approach, the ACCC notes that, as identified in stakeholders' submissions, debt currently issued by Airservices is rated at AAA. On this basis, the ACCC does not accept Airservices' proposed benchmark of an AA credit rating and considers that the benchmark of an AAA credit rating is more appropriate.

It is regulatory convention to estimate the debt risk premium using the same term applied in averaging the risk-free rate. Therefore, the ACCC has estimated the cost of debt margin using a five-year term for an AAA credit rating. Applying this approach resulted in a cost of debt margin of 0.34 per cent.⁸⁵ This is lower than Airservices' proposed cost of debt margin of 2.37 per cent, which was based on an AA credit rating and forward extrapolation of a five-year term to estimate a ten-year rate.

When submitting its formal price notification, the ACCC expects that Airservices will estimate the cost of debt margin applying a five-year term consistent with that used for the risk-free rate and based on an AAA credit rating.

Market risk premium

The value of the MRP applied by the ACCC in its other recent decisions is 6 per cent. On this basis, the ACCC is prepared to accept Airservices' proposed MRP of 6 per cent.

Summary

Applying the ACCC's adjusted nominal risk-free rate of 4.92 per cent and cost of debt margin of 0.34 per cent resulted in an estimated WACC of 8.37 per cent. The ACCC has undertaken an assessment of the extent to which this adjustment to the WACC affects Airservices' proposed required revenue, shown in table 7.6.

Table 7.8: ACCC's assessment of the effect of a variation in the WACC on Airservices' proposed required revenue (\$million)

	Airservices' 2011-12 proposed 9.95%	ACCC's 2011-12 estimated 8.37%	Difference
2011-12	862	844	18
2012-13	917	898	19
2013-14	970	950	20
2014-15	1 013	991	22
2015-16	1 060	1 037	23

⁸⁵ In estimating the cost of debt margin, the ACCC applied a methodology consistent with its approach in other industries it regulates. The ACCC used Bloomberg to obtain data for all AAA fixed rate bonds with a remaining maturity of between four and six years. The ACCC then subtracted the nominal risk-free rate from the most recent 20-day average of the yield to maturity of those bonds to estimate the cost of debt margin.

	Airservices' 2011-12 proposed	ACCC's 2011-12 estimated	Difference
Total	4 821	4 720	101

As illustrated by table 7.6, applying a WACC of 8.37 per cent reduces Airservices' required revenue by around \$101 million over the five-year period—a difference of 2.1 per cent.

As discussed above, the ACCC does not accept Airservices' proposed WACC as appropriate for this assessment primarily because Airservices has applied an AA credit rating in estimating the cost of debt margin when an AAA credit rating appears to be more appropriate. The ACCC also considers that a five-year term, and the use of a 20-day averaging period, in estimating the nominal risk-free rate and cost of debt margin is more appropriate. With the exception of the MRP, the ACCC has not undertaken an assessment, or formed a view, on the remaining WACC parameters. However, in the context of this draft price notification, the ACCC is prepared to accept Airservices' approach to leave them unchanged from 2004-05.

The ACCC considers that Airservices should address the ACCC's comments on the nominal risk-free rate and cost of debt margin prior to submitting its formal price notification. Any resulting adjustment to the WACC should be reflected by an associated adjustment to the proposed required revenue and prices for users.

8 Pricing and structure of prices

The purpose of prices surveillance is to achieve efficient prices and protect consumers in markets where competitive pressures are not sufficient to do so. Efficient pricing is concerned with both the level of prices, and the way in which prices are structured in order to recover revenue from different user groups

In the first instance, the ACCC undertakes an assessment of whether the proposed price increases are reasonable given the business's revenue requirements. This provides a check on whether the business is generating monopoly profits, and is done through the building-block model (see section 7). It is concerned principally with the *overall level* of prices. The ACCC is also interested in the efficiency of the business's cost base, as this will affect the level of prices and magnitude of any price increases.

In assessing the structure of prices, the ACCC will generally be interested in whether there has been or is likely to be an adverse impact on the efficiency of resource allocation decisions by the business and its customers. That is, whether the prices of service lines or prices at certain locations are likely to distort demand for the services.

Principles for efficient pricing

In a general sense the ACCC is reluctant to prescribe individual charges at too fine a level of detail. While monopoly service provision may raise concerns about the level of prices, it is generally considered that businesses possess greater motivation and information than third party arbiters to find price structures that best recover costs and

maximise network usage. For example, it is not feasible or desirable to simply increase each price by a proportion to reflect increases in total costs. This approach would be insufficiently subtle to accommodate the commercial judgments which must take place at a micro level, in particular the sensitivity of different users to price changes (price elasticity of demand).

Nevertheless, there are some tests of costs that the ACCC may conduct to gain a level of comfort with the efficiency of proposed prices.⁸⁶ Generally, setting prices of a service below incremental cost may encourage inefficient over-use of that service, while setting prices above stand alone cost could provide Airservices with monopoly returns.⁸⁷

When considering individual charges, it is relevant to consider the likely effect on demand of any increase in price. Inverse elasticity pricing (or Ramsey-Boiteux pricing) involves levying higher charges for those products for which demand is least responsive to changes in these charges. This leads to the recovery of costs in a manner which minimises the loss of transactions.⁸⁸

Qualifications and constraints

The ACCC is required to examine Airservices draft price notification taking the policy parameters in which it operates as given. Airservices is a government owned entity that provides services as required by the aviation safety regulator, CASA. Under section 46 of the Airservices Act, Airservices is required to operate as a commercial entity, with the expectation that it will provide an annual dividend to the Government. Implicit in this is a requirement to recover costs of the entire business, that is, that the Government does not have a policy that any use of the services will be taxpayer funded. Further, Airservices is required to provide services at any location if directed to by CASA.

Airservices has adopted a hybrid approach to pricing, which involves a mix of network pricing and location specific pricing. As a result, some services, or services in some locations over-recover their costs, and other services and locations under-recover. In some cases, prices do not recover incremental costs of providing the service.

⁸⁶ See ACCC, *Preliminary View: Airservices Australia Draft price notification*, November 2004, section 9.

⁸⁷ In adopting Faulhaber's approach to testing for cross- subsidies in prices of a regulated multi-product firm, the ACCC noted that 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. (ACCC, *Preliminary View: Airservices Australia Draft Price Notification*, November 2004, p. 90).

⁸⁸ The Ramsey-Boiteux method of cost allocation involves allocating common costs between users with the objective of maximising efficiency. In circumstances where demand 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.

Airservices' requirement to recover costs across entire business

In assessing Airservices' proposed structure of pricing, the ACCC must consider Airservices' requirement to raise sufficient revenue to recover its costs across the regulated services.

In 2004-05 the ACCC outlined its pricing principles for efficient pricing and allocation of fixed and common costs. Its subsequent analysis highlighted areas where it considered cross-subsidies existed, as some services did not recover even incremental costs. The ACCC did not consider cross-subsidisation to be a concern from an efficiency perspective in itself, and identified the circumstances under which it would be a concern as:

- if competition were to be introduced for the provision of certain services provided by Airservices, as the cross-subsidy could lead to inefficient entry, or
- if the level of cross subsidy was such that regional and GA airports were being kept open when the value of these airports to their users is less than the costs of these airports.⁸⁹

The ACCC further considered that 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.

It is important to note that, in respect of ARFF, the ACCC remains of the view, as it stated in its 2005 decision, that it appears unlikely that the market for ARFF services will be opened up to competition in during the period covered by this price notification. Given this, the proposed pricing structure (that is, basis of charges, cross-subsidies between en route and TN and ARFF) would not distort entry decisions.

The second scenario that the ACCC identified as a potential concern was where services were priced below incremental cost (at regional and GA locations) such that airports remain open when their value to users is less than the cost of the airport. In its 2004 preliminary view, the ACCC stated that it had not been provided with any evidence of this. In order to make an assessment of structure of prices in this context, the necessary information regarding price elasticities of various user groups at each location, including any cross elasticities or complements, has not been available. That said, from observation of past and present activity, it would appear that demand at major airports is relatively insensitive to price, when compared to regional and smaller airports.⁹⁰

Equity considerations

Inverse elasticity pricing can be at odds with concepts of fairness and equity across user groups in the sense that charges for some services, or in some locations, may not be limited to the cost of providing the service that they use. Prices for other services, or

⁸⁹ ACCC, *Preliminary view: Airservices Australia Draft Price Notification*, November 2004, p96.

⁹⁰ Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, January 2002, p. x. and Airservices Australia, *Draft price notification*, March 2011, p. 55.

services provided in some locations, may be lower than the full cost of providing them. Some groups may be concerned that they are effectively subsidising other businesses using those services.

As an economic regulator, the ACCC's role in assessing price structure proposed by a declared firm under Part VIIA of the CCA focuses on those situations where there is evidence that a proposed pricing structure issue is likely to create distortions in demand or where there are clear opportunities for more equitable outcomes through pricing without creating such distortions.

Inverse elasticity pricing attempts to approximate the relative value of a service to different users, as is reflected in their willingness or capacity to pay. This is consistent with economic efficiency principles because users are paying according to the value they attribute to the product or service. Indeed inverse elasticity pricing enables the reduction of deadweight losses that are brought about by loss of economic activity as a result of prices being high such that some users leave the market.

The ACCC assesses the level of prices Airservices charges its customers in the context of its demonstrated revenue requirements, the efficiency of its cost base, and efficiency of pricing. Further, the ACCC is required to make its assessment within the existing policy framework. Broader questions relating to policy (for, example, how any shortfalls should be funded) are outside the scope of the ACCC's assessment of locality notices under Part VIIA. These issues are most appropriately addressed by the Government.

Airservices' proposed price path

Airservices is proposing a five-year pricing arrangement that involves changes to its charges for terminal navigation (TN) and aviation rescue and fire fighting (ARFF) services. Charges for en route services are to remain unchanged.

Table 8.1 shows that the change in weighted average price varies from year to year. On average, Airservices is proposing to increase TN prices by 0.6 per cent per year and ARFF prices by 6.1 per cent per year (based on the weighted average prices).

Table 8.1: Airservices' proposed weighted average price changes (per cent)

	2011-12	2012-13	2013-14	2014-15	2015-16	Average annual
TN	1.9	0.8	0.1	(0.1)	0.2	0.6
ARFF	7.8	8.6	6.6	5.1	2.5	6.1

Source: Airservices Australia, Draft price notification, March 2011, p. 4.

Airservices' approach to pricing structure and cost allocation remains largely consistent with the approach taken to its 2004-05 LTPA. Airservices submitted that increases in prices for TN and ARFF services, while holding en route prices constant, is part of its strategy to move TN and ARFF services closer to their fully allocated cost levels, while avoiding large price shocks in the transition.

Airservices has provided details of the proposed changes to pricing on p. 16 of its draft price notification.

The ACCC's approach to pricing structure in this section

The ACCC's assessment of the structure of prices in Airservices' draft price proposal separately considers cost allocation, pricing across services and locations, including the basin approach to TN pricing, basis of charges, and timing of cost recovery.

8.1 Allocation of costs

8.1.1 Airservices' position on allocation of costs

Airservices described its method of cost allocation on pp. 45-48 of its draft price notification. Airservices noted that it has retained its 2004-05 LTPA approach to allocating common costs on the basis of activity.

For direct costs, Airservices submitted that its standard costing approach provides for standardisation of costs for similar inputs across locations. In taking this approach, it stated that it seeks to smooth any cost anomalies that are not location driven, and provide a cost base that better reflects the level of service and types of assets employed at a particular location.

Airservices submitted that the standard costing does not increase or decrease the overall level of costs, but that standard costs have been calculated to ensure that total recovery is unchanged.⁹¹

8.1.2 Views of interested parties on allocation of costs

The ACCC sought comment from interested parties on the appropriateness of the proposed methods for allocating direct costs as well as fixed and common costs.

RAAA, Rex and BARA have raised no issues in relation to the proposed methods.

IATA submitted that the appropriateness of the proposed methods is 'meaningless once caps on charges are implemented for terminal navigation services, network pricing applied for Category 6 ARFF services and cross subsidies applied for en route services'.⁹² Further, IATA stated that it did not support standardisation of costs and that users should pay for the actual costs incurred.

VAA stated that, given it is a user pays model, the use of standard costing may distort the proposed cost recovery of both major and regional ports. Therefore, VAA

⁹¹ Airservices Australia, *Draft price notification*, March 2011, p. 45.

⁹² International Air Transport Association, *IATA submission in response to the Australian Competition & Consumer Commission (ACCC) "Issues Paper" on Airservices Australia's Draft Price Notification*, May 2011, p.16.

submitted that it would like assurance that regional ports will not be disadvantaged. VAA submitted that the allocation of fixed and common costs on a location specific basis is an acceptable allocation as it is equitable to both major and regional ports. VAA stated that it would like a clearer explanation of how resource requirements have been derived on a site by site basis.

Qantas considered that the use of a standardised approach for salary costs and some operational costs in theory may have some merits. Qantas submitted that it was not able to comment on the appropriateness of the allocation of direct costs and standardisation without specific details or models to compare the situation with and without standardisation. Qantas proposed its own cost allocation method, the two part tariff approach, where variable costs are recovered under a location specific model and fixed costs are networked across the segments.

8.1.3 ACCC's views on allocation of costs

In its assessment of the 2004-05 LTPA, the ACCC noted that Airservices' method of cost allocation was one which is reasonably likely to result in allocations which broadly reflect users' capacity to pay.⁹³

This is consistent with the inverse elasticity rule, which suggests allocating costs to services and locations in inverse proportion to the elasticity of demand for the service will maximise economic activity.

However, the ACCC was unable to ascertain the degree to which Airservices' method would serve efficiency given:

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

That said, the weight of qualitative argument suggested to the ACCC that Airservices' approach to the allocation of distributed costs between locations on the basis of activity is a reasonable and transparent approach to allocation costs when there is no clear (causal) basis for apportioning these costs between services.⁹⁴

The method of cost allocation of fixed and common costs has been relatively uncontroversial amongst stakeholders, and the ACCC's view on allocation of costs remains consistent with its 2005 decision.

The ACCC does note stakeholders' comments relating to the interaction with the cost allocation method of the regional and basin caps, and network pricing of Category 6 ARFF services. This is discussed in more detail below.

⁹³ ACCC, *Preliminary view: Airservices Australia Draft Price Notification*, November 2004, p. 78.

⁹⁴ ACCC, *Final decision: Airservices Australia Price notification*, December 2004, p. 25.

In relation to Airservices' standard cost method for allocating direct costs for services across locations, the ACCC is satisfied that Airservices has applied the method to its financial model in the way it has described. The ACCC sees merit in the standard costing approach to removing anomalies in prices for services across locations.

8.2 Pricing across services and locations

8.2.1 Airservices' position on pricing across services and locations

The principles underlying Airservices' pricing structure are contained in the draft price notification. Airservices stated that the current price proposal reflects a further reduction in the cross-subsidy from en route services, with nominal prices remaining constant (and therefore reflecting real reductions). TN and ARFF prices are increasing. Over the period of the current draft proposal, en route services are projected to over-recover their costs by \$94.5 million, and TN and ARFF services are projected to under-recover costs by \$94.5 million collectively (table 8.1). By comparison, the 2004 LTPA estimated that en route services would over-recover their costs by \$103.2 million, and TN and ARFF would under-recover by \$104 million. Airservices stated that the overall level of the en route price subsidy would drop from \$0.33 per tonne in 2012 to \$0.07 per tonne in 2016.⁹⁵

Airservices estimated the shortfall in cost recovery in 2010-11 as a result of the regional caps on TN services to be \$6 million,⁹⁶ and the shortfall for ARFF services (via the uniform price charged for category 6 services at all locations) is estimated to be \$31 million in 2011-12.⁹⁷ These shortfalls would be covered by revenue collected from en route services.

Table 8.2: Service surplus/(shortfall) (\$million)

Service	2011-12	2012-13	2013-14	2014-15	2015-16	Total
En route	32.8	23.8	15.0	14.4	8.5	94.5
TN	4.8	(4.4)	(9.7)	(9.1)	(8.5)	(26.9)
ARFF	(22.5)	(19.6)	(13.3)	(6.4)	(5.9)	(67.7)
Total	15.1	(0.3)	(8)	(1.1)	(5.9)	

Source: Airservices Australia, *Draft price notification*, March 2011, p. 39.

According to Airservices, the increased rate of under recovery of costs at regional and GA airports over the five year period is due to the added costs associated with a Ministerial Direction to install radar services at the specified regional locations, and costs associated with the introduction of the Class D Airspace category at some GA airports. According to Airservices, it is still on a trajectory to reduce the level of under recovery at regional and GA locations beyond the current five year price agreement.⁹⁸

⁹⁵ Airservices Australia, *Response to ACCC's additional information request*, 4 April 2011, p. 7.

⁹⁶ Airservices Australia, *Draft price notification*, March 2011, p. 11.

⁹⁷ Airservices Australia, *Draft price notification*, March 2011, p. 14.

⁹⁸ Meeting with Airservices, May 18 2011.

Airservices noted the challenges associated with quantifying the likely demand impacts of higher charges at regional and GA airports. The number and complexity of costs that airlines must factor in, particularly given the variation in business models and pricing practices of different carriers, makes isolating and measuring the impact of the Airservices-component of costs difficult. Airservices stated that it has not found a way to model the impacts of increased prices. It has relied on feedback from regional airlines and airports. Airservices did not believe it was in a position to determine the point at which distortions in demand will arise.⁹⁹

Airservices submitted that it has received strong feedback from regional and GA operators that the TN price increases in the previous LTPA were not sustainable into this agreement, and that a rate aligned with inflation could be sustained without significant dislocation. In the case of ARFF price increases, Airservices submitted that a number of large operators expressed concern at the rate of increase in the December 2010 (consultation) proposal and it reduced the rate of increase as a result.¹⁰⁰

Basin pricing

Airservices stated that TN ‘prices at GA airports in a capital city basin will be capped (the Basin Cap). The shortfalls from price capping these services are funded from the major airport in the capital city basin. This is estimated at \$24 million in 2010-11’.¹⁰¹ Prices at major capital city basin airports have been increased by between 5 per cent and 20 per cent to fund secondary airports.¹⁰²

Airservices provided additional information and evidence to the ACCC regarding basin pricing. Airservices submitted that the operation of secondary airports in capital city basins has a significant positive impact on reducing congestion and improving safety at major basin airports. It stated that operationally and procedurally there are significant air traffic control interdependencies across the services operating into and out of basin airports.¹⁰³

Airservices further submitted that the operation of secondary airports effectively segregates traffic, minimising airspace complexity and maximising regular passenger transport operations’ efficiency.¹⁰⁴

According to Airservices, the user base at GA airports is diverse and demand is quite price sensitive.¹⁰⁵ Airservices submitted that if the full service costs were priced for secondary basin airports (up to \$130 per tonne landed) Airservices charges’ would have a distortionary impact on the airport market, making them too costly to use and ultimately unviable.

⁹⁹ Meeting with Airservices, May 18 2011.

¹⁰⁰ Airservices Australia, *Response to ACCC’s additional information request*, 4 April 2011.

¹⁰¹ Airservices Australia, *Draft price notification*, March 2011, p. 10.

¹⁰² Airservices Australia, *Draft price notification*, March 2011, p. 44.

¹⁰³ Airservices Australia, *Response to ACCC’s additional information request*, 4 April 2011.

¹⁰⁴ Airservices Australia, *Response to ACCC’s additional information request*, 31 May 2011.

¹⁰⁵ Meeting with Airservices, 18 May 2011.

With no alternative aerodrome, Airservices stated that it would not be able to operate the priority sequencing programs,¹⁰⁶ making it feasible for non-RPT (regular public transport) operations to use the major capital city airports.

Where price sensitive flying schools and recreational operators have alternative non-towered locations to which they can relocate, Airservices submitted it was likely that their shift in demand would lead to that non-towered aerodrome requiring a tower, resulting in replication of infrastructure at considerable cost. It stated that other small, less price sensitive business aircraft relocating to the major airports would increase the mix of fleet and airspace complexity, leading to increases in airline delays and costs. Airservices cited a study completed in 2009 suggesting a 15 minute delay per day across each of the primary airports would cost the airlines up to \$11 million per annum.¹⁰⁷ In addition, Airservices submitted that reduced airport capacity would be likely to add to airlines' costs.

Airservices argued that an alternative option to maintain the price cap at secondary airports and recover costs from all uncapped airports on basis of traffic volumes would disadvantage Sydney airport the most (where users would be required to pay up to \$5 million more per annum), Brisbane and other locations such as Hobart, Canberra and Gold Coast would also be disadvantaged. Adelaide and Perth would benefit the most.

8.2.2 Views of interested parties on pricing across services and locations

Several stakeholders expressed concern about the level of cross-subsidies present in the pricing across services lines (from en route to TN and ARFF), and across locations (major capital airports subsidising TN and ARFF in regional locations, and TN at GA airports).

While the reduction in under recovery of costs in the TN and ARFF service lines was welcomed by some of the major airlines, it was considered that the rate of reduction was not rapid enough.

Linked to these concerns are arguments by the major airlines that Airservices is taking advantage of its government owned monopoly status, providing assistance to domestic industries (regional and domestic airlines, and GA operators).

In addition, airlines argued that it is reducing commercial opportunities for, and competition between, international airlines. Airlines have also argued that Airservices' pricing methodology is entrenching its monopoly status by making competition for ARFF unviable, as regional airports have no incentive to provide competing ARFF services (BARA).

International airlines were generally opposed to any cross subsidies between services and locations, on the basis of equity and efficiency.

¹⁰⁶ The priority sequencing programs give priority to RPT (regular public transport operations) over other aircraft operations at the major capital city airports.

¹⁰⁷ Airservices Australia, *Response to ACCC's additional information request*, 31 May 2011.

IATA opposed the cross subsidies from en route to TN and ARFF. It recognised that the cross subsidy is to be reduced over the period but stated that en route users were paying more than \$90 million over the period. IATA did not support charging on the basis of price elasticity and considered it an abuse of monopoly position.

Singapore Airlines commented on a lack of alignment with the pricing principles adopted by ICAO and those of Airservices. Singapore Airlines was of the view that the operation of non-viable infrastructure should be funded by the users or the Government, if the community need for the service is considered to be of economic importance. Singapore Airlines submitted that increasing the reliance of domestic and GA services on cross-subsidisation is flawed and fails to provide a reasonable and non-discriminatory long term path for the pricing of those services. Air New Zealand also argued that mechanisms to address shortfalls should be established outside Airservices' pricing structure.

United Continental Holdings submitted that it supports a funding plan that is transparent and charges each user fairly, equitably and in a manner that promotes efficient use of public resources.

BARA objected to price increases of TN and ARFF services at major international airports for the purpose of subsidising domestic and general aviation airports, and considered that the cross subsidy 'fails the economic efficiency test'. BARA suggested that the minimum prices that should be levied for TN and ARFF services at each location be set with reference to their avoidable cost.

Air New Zealand submitted that the continuation of cross subsidies created little incentive for Airservices and its customers to consider the true cost of providing services at particular locations and to consider alternative means of services provision, such as competition where possible.

Some airlines questioned the level of subsidisation across services and locations, and the rate at which it was to be decreased.

Cathay Pacific welcomed the reduction in cross subsidisation, but considered the level should be reduced more quickly.

BARA was concerned that the price caps for TN at regional airports were arbitrary and contradicted Airservices' statement that each location should recover its location specific costs.

IATA expressed concern that almost all the loss making terminal locations were forecast to generate even greater losses by 2015-16. Similarly, IATA expressed concern that a few ARFF service locations were subsidising all the remaining locations through the Category 6 caps, and that the cross subsidy becomes greater over the period.

IATA argued that the basis for charging for TN services was meaningless once the caps are applied. IATA did not accept the limiting of price increases to inflation as it maintained this was not enough to move towards full cost recovery.

Some stakeholders, conversely, argued that charges at regional airports were too high. Some regional operators also expressed a preference for network pricing (for example, RAAA, Australian Regional Tourism Network).

Qantas supported the continuation of subsidies for regional TN caps via enroute services. Qantas stated that many enroute services are also users of regional class D towers costed under the TN charges. Qantas advocated the networking of fixed costs recognising the lumpy nature of infrastructure costs and overheads.

Some stakeholders (for example, Qantas, RAAA, Rex) expressed concern regarding the increases in ARFF prices. Qantas submitted that the rate of increase for ARFF services was steep, and would affect demand and recovery of costs in a number of locations. It recommended a less steep increase with review of demand.

RAAA submitted that it was strongly opposed to location specific charges and supported network based charging. RAAA argued that location specific charging is highly disadvantageous to regional operators. RAAA further submitted that the number of towns and communities serviced by regional carriers has more than halved over the past 25 years. RAAA considered that USA and Canada have been strong supporters of network pricing.

Some stakeholders noted the impact that increased charges and location specific pricing would have on regional communities. RAAA expressed concern regarding the compounding of social inequity as a result of affordability and access to air services for Australians living in regional and remote areas. The Australian Regional Tourism Network submitted that higher charges for regional services made it even more difficult for regional airports to attract and maintain air services from major domestic carriers.

Aircraft Owners and Pilots Association of Australia noted that airports made no contribution to the air navigation infrastructure that supports the operations from which they make a profit.

Basin pricing

Stakeholders' concerns regarding the basin pricing approach were common in many respects to broader stakeholder concerns regarding cross-subsidisation across service lines and locations, as the basin pricing approach involves price caps at GA airports with shortfalls funded by major capital city airports within that 'basin'.

BARA noted that cost recovery levels at GA airports were very low, ranging from around 15 per cent to 35 per cent, with the average at around 20 per cent. BARA noted that these levels of under recovery were being funded by the major international airports. BARA noted that the level of subsidy was \$24 million in 2011-12, and increased to around \$28 million by 2015-16.

BARA further argued that there was scope for TN charges to be increased significantly before they were on par with the cost of using the major airport (when combined with parking costs), and concluded that they are excessively low and are not needed to influence GA users' decisions to not use the major airport. It was argued that the market would in any case deal with any congestion issues arising from GA operators using the major airports. BARA also concluded that most of the annual subsidy

provided to GA aircraft through TN pricing is general assistance unrelated to its proximity to a major international airport.

Stakeholders (for example, United Continental Holdings, BARA) argued that many GA operators are wealthy individuals, and if the government wishes to provide assistance to flying schools it should do so explicitly through the budget.

BARA noted that Airservices had not attempted to address the ACCC's concerns expressed in its views on the previous LTPA that more analysis needed to be done by Airservices to describe the ways in which basin pricing resulted in benefits to users of the major capital airports.

IATA also argued that there is excess return when looking at the return on assets on basins as a whole and therefore the excess was being used to subsidise other services areas (other than just the airports in the basin).

Other stakeholders supported the basin pricing concept, and suggested some modifications be made to either the level of pricing or the inclusion of secondary airports in existing basins.

Qantas submitted that the Sunshine Coast and Gold Coast should be considered part of the same basin as Brisbane airport, and Avalon should be considered part of the same basin as Tullamarine airport. Qantas argued that relatively low TN charges at Brisbane and Tullamarine would lead to demand switching from Sunshine Coast and Gold Coast into Brisbane, and from Avalon to Tullamarine. Qantas noted that empirical evidence suggested the demand switching effects are both statistically significant and material.

Qantas also submitted that there are common costs amongst these airports in that they share Airservices services. Qantas noted that flights in and out of the Gold and Sunshine coasts frequently used Brisbane radar and class D tower services and vice versa, and flights in and out of Avalon frequently use Melbourne radar and class D tower services.

The RAAA submitted that the basin differential could be considered excessive with prices at GA airports in 2016 up to 172 per cent higher than those at the major airport. The RAAA argued that the prices need to be kept sufficiently similar so as not to deter GA users from using the secondary airport.

Cathay Pacific submitted that Australia needed more alternative airfields and that this could be achieved with the current alternative airports if they had longer hours of service of air traffic control and ARFF. Cathay Pacific argued that these would also return a greater overall industry saving by way of reduction in fuel carriage.

8.2.3 ACCC's views on pricing across services and locations

The ACCC notes that the structure of pricing across services and locations is largely unchanged from that which was implemented in the 2004-05 LTPA and, therefore, considers the analysis of the pricing structure in its 2004-05 assessment, including its subsequent ARFF decision, continues to apply.

As noted above the ACCC is reluctant to be prescriptive about structure of prices. It employs the building block model to ensure monopolists' prices are set to provide reasonable rate of return to the business. The ACCC is also, as noted earlier, interested in the efficiency of the business's cost base. However, the ACCC considers that individual organisations are in a better position to understand how to best recover costs and maximise usage of services across the business. It focuses, therefore, on those areas where the structure of prices may lead to distortions in economic activity.

In its 2004-05 preliminary view the ACCC identified a degree of 'cross-subsidisation' of TN and ARFF services at regional and GA locations by en route and TN services at radar locations.¹⁰⁸ The ACCC considered that the cross subsidies would be of concern from an efficiency perspective (provided prices exceed marginal costs) if there was the prospect of competition being introduced to a service, or if the level of prices at GA or regional airports were low such that airports were being kept open when the value of these airports to their users is less than the cost of the airports.¹⁰⁹ At the time the ACCC said that it had not been provided with any evidence that either of these conditions applied.

In 2003, the ACCC encouraged Airservices to consider alternatives to its price structure given the divergent views of stakeholders. The ACCC acknowledges the actions taken by Airservices since the previous LTPA with respect to the restructure of ARFF prices in 2006, pricing options review, and the TN review.

The ACCC notes stakeholders' concerns regarding the equity of pricing given the under recovery of costs for services at regional and GA locations.

The ACCC supports the transition to location specific pricing, and would not support the return to network pricing. In the absence of any detailed evidence relating to price elasticities and the impact of Airservices' prices on carriers' costs, the ACCC considers that it is not unreasonable to expect that faster moves to cost reflective, location specific pricing could have adverse effects on demand at regional and GA airports.

The ACCC further acknowledges the impact of regulatory changes and constraints for increasing prices leading to increased under recovery across these locations in the five year period. The ACCC would expect, however, that the move to recovery of costs by regional and GA airports would continue to occur.

The ACCC has not been provided with evidence that Airservices' pricing at any of the locations is creating distortions in economic activity, and would be reluctant to suggest an alternative pricing structure be implemented. The ACCC would expect that

¹⁰⁸ The ACCC adopted the G.R. Faulhaber methodology for determining whether cross subsidies are present in the prices of a regulated multi-product firm. According to this approach '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 group of services is at least as great as the incremental cost of providing the services of 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'. GR Faulhaber, *Cross-Subsidisation: Pricing in Public Enterprises*, American Economic Review, 65(5), December 1975, 966-977.

¹⁰⁹ ACCC, *Preliminary View: Airservices Australia Draft Price Notification*, November 2004, p. 96.

Airservices, through ongoing consultation with users, would be in a position to respond appropriately to any losses in infrastructure usage.

Basin pricing

In 2004, the ACCC encouraged Airservices to more fully develop the basin pricing concept. At that time Airservices indicated its intention to continue working with users to further clarify the interdependencies and benefits.¹¹⁰

The ACCC acknowledges stakeholders' concerns in relation to secondary basin airports being subsidised by the major airports. The ACCC notes concerns that some users of the GA airports may be in a financial position to bear increased TN charges. However, the ACCC also acknowledges Airservices' contention that GA locations are price sensitive, and that increased charges have the potential to lead to reduced demand, therefore reduced utilisation of existing infrastructure, and potentially aerodrome closures.

The ACCC notes RAAA's submission that the basin price differential may be viewed as excessive when in 2016 charges at the secondary airport would be up to 172 per cent higher than the major airport. Such comparisons must take into account the average total fee paid per aircraft, given the vast differences in weight of aircraft used at the secondary and major airports respectively.

The ACCC notes Airservices' rationale in relation to basin airports in the additional information provided to the ACCC and summarised above. It appears there are arguments to support the notion that secondary airports provide some positive externalities to the major airports, although there is a lack quantitative evidence regarding the magnitude of these.

The ACCC is mindful, however, that in the absence of any evidence to the contrary, the subsidised prices at GA airports may not be wholly reflective of positive externalities. That is, assuming that positive externalities exist, the ACCC is unable to ascertain whether they equate to the subsidy to the GA airports.

To the extent that the subsidy exceeds the value of the positive externalities, the rationale for imposing basin caps on TN charges at GA locations may be, at least partially, akin to that for regional locations. Airservices has contemplated some of the expected implications of spreading costs to uncapped airports.

The ACCC's view in relation to basin pricing is consistent to that regarding price structure more generally.

In response to Qantas' suggestion to include Sunshine Coast and Gold Coast airports in the Brisbane airport basin, and Avalon in the Melbourne airport basin, the ACCC considers that this would be inappropriate given the extent to which the secondary airports are substitutes for proximate major airports. In contrast the current secondary basin airports, which cannot effectively service regular passenger transport operations, can more appropriately be characterised as complements to the major airport.

¹¹⁰ ACCC, *Preliminary View: Airservices Australia Draft Price Notification*, November 2004, p. 82.

8.3 Basis of charges

Supporting information provided by Airservices is included at pages 51-52 of its draft price notification.

Airservices proposed to continue the use of maximum take-off weight (MTOW) as the basis of charges for TN, ARFF and Enroute service charging calculations.

To simplify the determination of MTOW for larger aircraft between different operational configurations of very similar aircraft, Airservices proposes an averaging the MTOW for each aircraft type. This averaging will only apply to aircraft weighing greater than 15.1 tonnes. The average MTOW will be aircraft type-specific (e.g. B747-400).¹¹¹

Airservices' proposal also includes a cap on the maximum weight to be used of 500 tonnes.

8.3.1 Weight based charges across all services

Airservices' position on weight based charges

MTOW-based charges

In respect to the use of weight-based charges across all of its services, Airservices has submitted that, in setting prices, it largely complies with international policy (set out in ICAO's *Policies on Charges for Airports and Air Navigation Services* document).¹¹²

Airservices submitted that MTOW is correlated to passengers on board and this is generally accepted internationally as a reasonable basis for levying charges and is well entrenched in most ANSP charges.

Airservices submitted that it recognises international policy that discourages the direct relationship between MTOW and charges. Some countries have applied a power of less than 1 to the MTOW (e.g. MTOW to the power of 0.9), while others have applied a ceiling or cap on MTOW. The current charges for TN and ARFF are in direct proportion to MTOW, and Airservices aims to address this issue through this notification (by introducing a maximum weight cap of 500 tonnes – as discussed below).

Airservices has advised that, in modelling these scenarios, it has found that applying a power had a very significant negative impact on smaller operators while larger operators benefited significantly. However, Airservices' findings suggested that a 500 tonne weight cap could be introduced without a significant impact on any particular operator given the limited number of A380 operations currently in service.

¹¹¹ A table of MTOWs applicable for each aircraft type greater than 15.1 tonnes is shown at Appendix 2 of Airservices' current draft price notification.

¹¹² http://www.icao.int/icaonet/dcs/9082/9082_8ed_en.pdf

Additionally, to simplify the determination of MTOW for larger aircraft, Airservices proposes that an average industry MTOW will be applied.

Weight cap (500 tonnes)

As noted above, Airservices submitted that the main driver of the pricing proposal is the removal of pure proportional MTOW charging. Airservices also noted that the introduction of the 500 tonne cap is in response to strong consultation feedback on the need to move away from a pure weight based charge.

Airservices claimed that the cap is also aligned with notions of efficiency incentives, and is intended to support the operational efficiencies that large aircraft provide with regard to capacity, fuel efficiency and noise.

Airservices also submitted that, at the request of a number of international operators, it reviewed whether the 500 tonne cap should be reduced to include some new aircraft due to arrive soon that weigh in at 450 tonnes.

Airservices estimates savings to aircraft over 500 tonnes that have been recovered across all other operators is \$2-\$4 million per annum.¹¹³

Airservices has noted that it has considered whether its pricing objectives should be adjusted to provide incentives for efficient operations in line with obligations under the Airservices Act concerned with minimising the environmental impact of aircraft operations. However, Airservices submitted that discussions with industry stakeholders has indicated that further work to better define efficiency and identify relevant operations would be required before this became a part of its pricing objectives.

Views of interested parties on weight based charges

The ACCC's issues paper sought comments on both the existing system of weight-based charges for each of the service lines and the proposed changes to pricing.

MTOW-based charges

Qantas submitted that MTOW-based charging, with a cap or discount for heavier aircrafts, was its preferred basis for charging. It also stated that it supported the averaging of MTOW across the fleet as it simplified administration and invoicing. Both Rex and RAAA were also supportive of weight based charging.

BARA was not opposed to weight-based charging. However, it submitted that the current prices are contrary to ICAO pricing principles, and suggested that:

- For TN services, a single charge per flight is appropriate. The charge can take aircraft weight into account, but less than in direct proportion.
- For en-route services, ICAO recommends a combination of distance flown and weight. Airservices' proposal to cap the weight of the weight of aircraft at

¹¹³ This assumes some growth in A380 operations with the introduction of A380 operations projected to occur in Brisbane and Perth in 2014 and 2016.

500 tonnes is consistent with ICAO policies for the A380. However, the proposed prices do not address the need to take weight into account in less than direct proportion for all other aircraft.

A number of parties (IATA, Cathay Pacific Airways, Emirates, United Continental Holdings and VAA) submitted that they were opposed to weight-based charging. For example, IATA stated that weight based charging cannot be economically efficient and submitted that there should be a complete removal of weight from the charging formula given that weight has little influence on ATC costs and provides incentives to increase the number of smaller aircraft. IATA also suggested that ATC en route charges should be solely based on distance (and, ultimately, on time).

Cathay Pacific suggested some alternatives to the weight cap, and submitted that if weight based charging were to continue, it would support the application of an average MTOW, as proposed by Airservices.

Emirates argued that MTOW is a measure of fuel capacity and thus has no relationship to Airservices' costs of providing services to particular aircraft. Emirates submitted that:

- In respect of en route charging, there is no economic justification for the use of weight-based charges, noting that it increases the operating costs of airlines that require greater fuel capacity and that pricing should only be based on distance.
- In respect of TN prices, TN prices should be a fixed fee per landing and takeoff as same service is provided regardless of MTOW. Otherwise, customers are penalised for fuel capacity of the aircraft and incentivised to downgrade to smaller aircraft, leading to inefficient capacity investment. However, that if weight were to be taken into account, it should be the square root of weight rather than taking into account the direct proportion.
- In respect of ARFF charges, weight should be removed and a flat fee per landing, per category of aircraft should be levied.

United Continental Holdings submitted that weight based charging is not equitable and does not promote efficient use of air space because both small and large aircraft place the same burden of tracking, monitoring and guiding on the ATC system. United noted that the use of larger aircraft is more efficient use as it transports more passengers.

VAA strongly opposed the use of MTOW and would want to reserve the right to review it during the proposal period. VAA submitted that average MTOWs 'removes the ability of VAA to manage its fleet capability through differing MTOWs and removes any competitive advantage that may be achieved through more efficient fleet planning. VAA noted however, that if Airservices were to implement average weights, it should be the company average weight and not an industry average weight.

Weight cap (500 tonnes)

Although there was a mixed level of support in submissions for weight-based charging (insofar, at least, as charges would be proportional to MTOW), there was general support for the introduction of a weight cap in submissions. For example, Emirates,

which opposes weight-based charging, expressed the view that the cap was a ‘step in the right direction’ because it encourages efficiencies provided by the A380 aircraft.

RAAA and Qantas were also supportive of the 500 tonne cap provided that industry has the ability to review and change it in the future.

As noted above, BARA was of the view that weight should be taken into account, but less than proportionally, and thus, the 500 tonne weight cap would be consistent with ICAO policies for A380 aircraft.

Cathay Pacific Airways was opposed to the 500 tonne weight cap as it submitted that the rationale for the level of the cap is not explained and that the cap is ‘discriminatory (i.e. it favours operators that use the A380) and introduces cross-subsidisation between operators’.¹¹⁴

IATA submitted that the 500 tonne weight cap is meaningless, as only one aircraft type will surpass such a weight.

ACCC’s views on weight based charges

In assessing the basis of prices in Airservices’ proposal, the ACCC considered the extent to which the prices promote efficiency.

As noted above, the ACCC considers that Airservices has superior information to the ACCC to be able to find price structures that best recover costs and maximise network usage. The ACCC, in assessing Airservices’ proposals, aims to ensure monopoly pricing is avoided through the assessment of the overall level of prices, through the use of the building block model, as opposed to undertaking a detailed analysis of the distribution and allocation of common costs and overheads through individual prices.

In assessing the basis of Airservices’ prices, the ACCC has had regard to:

- the likely effect of changes in Airservices’ basis of pricing on the level of demand
- the incentives provided by the basis of pricing to encourage efficient use of airspace
- Airservices’ objective of ensuring a relatively simple charging structure
- Equity considerations (for example, there is an equity argument that customers should not be required to pay more than the cost of providing the service to them).

MTOW-based charging

The ACCC appreciates that submissions have proposed a number of alternative approaches to MTOW-based charging, including en-route charges being based on distance only.

¹¹⁴ Cathay Pacific Airways, *Response by Cathay Pacific Airways*, May 2011, p. 3.

It is generally accepted that the value of the service is reflected in an aircraft's productive capacity.¹¹⁵ As the capacity and MTOW of an aircraft are related, aircraft MTOW is commonly used in charges to reflect the value of service. This is generally accepted internationally, and taking MTOW into account in aircraft navigation charges is virtually a universal practice.¹¹⁶

In particular, for enroute charges, virtually all ANSPs charge according to the MTOW and the distance travelled within the flight information region. In respect of terminal navigation, MTOW is also used as the key determinant, although rates vary.¹¹⁷

The ACCC accepts Airservices' submission that MTOW is generally correlated to the number of passengers (or amount of cargo) on board.¹¹⁸

That said, there may be some exceptions to this. For example, Emirates noted in its submission to Airservices' *Price Structure Options discussion paper*, August 2008, that weight-based pricing reduced the commercial opportunities of airlines that require greater fuel capacity to reach Australia.¹¹⁹

It can be said, more generally, that the value of the service to the user is generally linked to capacity to pay, which is important for determining efficient (Ramsey) pricing structures, as discussed in more detail above.

The ACCC appreciates the alternative pricing mechanisms put forward in submissions, such as a mechanism based on distance. However the ACCC considers that adopting a pricing methodology based only on distance will potentially ignore users' capacity to pay, which is likely to result in Airservices being unable to recover its overall efficient costs.

The same can be said of alternative mechanisms that align individual charges more closely to Airservices' costs of providing the particular service to the particular user: although such approaches have clear equity benefits, they are unlikely to provide a link between the price paid by the user and the user's capacity to pay, which may result in inefficient outcomes for Airservices and its users. These alternative mechanisms may also suffer from a significant level of administrative complexity (similarly to company-average MTOW measures discussed in the next section).

¹¹⁵ NAVCanada, *Service charges discussion paper*, 2005, pp. 9-10.

¹¹⁶ International examples include NAV Canada, Airways Corporation New Zealand, Deutsche Flugsicherung (Germany), Air Traffic Navigation Services (South Africa) and NATS (UK) (Airservices, *Price structure options discussion paper*, August 2008, Appendix 5 and page 45)

¹¹⁷ Airservices, *Price structure options discussion paper*, August 2008, page 45.

¹¹⁸ In its 2004 preliminary view on Airservices' ARFF draft price notification, the ACCC acknowledged that there may be a correlation between MTOW and RPT passenger numbers, although it had some doubts about whether this was the case at the lower end of the range for MTOW. This issue was addressed by Airservices in its 2005 proposal when it introduced a 15.1 tonne cut-off for RPT transport, and this was accepted by the ACCC, on the basis that noting that the majority of passengers would be captured by this distinction.

¹¹⁹ Emirates noted that the MTOW of the 258-seat Airbus A340-500 was 372 tonnes, which was substantially more than the 278-seat Airbus A330-200, which had an MTOW of 230 tonnes.

The ACCC recognises that these are important, but difficult problems. The ACCC notes that Airservices and users have explored various options, such as through Airservices' price structure consultation process in 2008, and Airservices has decided to retain MTOW as the underlying basis of charges.

The ACCC is comfortable with MTOW being used as a basis for Airservices' charges, but encourages Airservices to continue to engage with stakeholders to ensure this remains appropriate .

Industry versus company-average MTOW

The ACCC has also considered other MTOW-based measures proposed in submissions, such as the use of a company average weight instead of an industry average weight, or the use of a power of less than one for MTOW instead of a cap.

VAA raised the possibility of using a company average weight as opposed to an industry average weight in calculating MTOW-based charges.

The ACCC considers that the benefits associated with more precise charging options, such as the use of a company average weight, could be lower than the additional administrative complexity involved. Indeed, as noted above, a more complex pricing approach which might be closer to a theoretically efficient pricing structure may be counter-productive if it requires substantial effort and information to implement or if the costs of collecting charges from smaller operators are high relative to the revenues that would be raised. This is consistent with Airservices' pricing principles.¹²⁰

Thus, the ACCC considers that, on the basis of information before it, the industry averaging approach proposed by Airservices is reasonable.

MTOW cap versus less than proportional MTOW-based charging

The ACCC notes that, in setting charges, Airservices' principles dictate that prices should encourage economically efficient resource allocation, which includes for a particular service to cover its direct or marginal cost. The level of contribution to overheads should depend on the demand sensitivity of the activity to prices charged.¹²¹ This is consistent with the ACCC's preference for inverse elasticity pricing, which leads to the recovery of common costs in a manner which minimises the loss of transactions.

At a general level, the key difficulty the ACCC faces in assessing Airservices' structure of prices is the difficulty in ascertaining the price elasticity of various user groups. The ACCC notes that Airservices has not detected any evidence of its prices having a material impact on passenger demand (i.e. demand, overall, appears to be relatively price-inelastic).¹²² Additionally, Airservices submitted that, as many users will acquire a range of services, the changes for these users will offset each other to an extent.

¹²⁰ Airservices Australia, *Draft price notification*, March 2011, p. 21.

¹²¹ Airservices, *Price structure options discussion paper*, August 2008, p. 47.

¹²² Airservices Australia, *Draft price notification*, March 2011, p. 55.

All things being equal, the ACCC considers that the price elasticity of demand to land at a location is likely to be lower, the larger the aircraft or the greater the number of passengers on board (for example, if the number of passengers carried onboard is lower, a larger proportion of the price increase is borne by the end user). This is based on the assumption that MTOW is generally correlated with capacity to pay (as discussed above).

However, while this may be the case at a general level, there may be other factors that will significantly influence the decisions of aircraft operators and end users. For example, as Emirates submitted, some aircraft have higher MTOWs but relatively low passenger numbers, and this would mean that the end-user bears a larger proportion of a price increase.

ICAO, in recommending that charges should be set less than in proportionally to MTOW, evidently considers that there are efficiencies associated with larger aircraft.

On the basis of information available to it, the ACCC accepts that there will be certain efficiencies associated with larger aircraft. In particular, as submitted by United Continent Holdings, such aircraft make more efficient use of airspace because they transport more passengers. A greater utilisation of airspace by larger aircraft would not require a substantial increase in Airservices' costs and may result in a reduction of congestion at airports and positive environmental outcomes.

The ACCC would find it difficult to quantify any such efficiencies. In any case, the ACCC appreciates that Airservices' proposed cap appears to be a step in the right direction to ensure consistency with ICAO recommendations. However, this goal could also be achieved through the use of a power of less than one for MTOW-based charges.¹²³ This issue has been raised in submissions (e.g. BARA), and Airservices has stated that it considers that the introduction of a cap will essentially remove pure proportional charging, in line with ICAO recommendations.

The ACCC is mindful that Airservices should possess greater motivation and information than the ACCC to be able to find price structures that best recover costs and maximise efficient usage. For example, the ACCC considers that there is a risk that the use of a power less than one in setting charges for TN and ARFF would have the unintended result of discouraging price-sensitive users (i.e. smaller aircraft),¹²⁴ and thus a greater proportion of costs would need to be recouped from the remaining users in the future. This runs counter to Ramsey-Boiteux pricing, and, on that basis, the ACCC does not object to MTOW being used in the way that is currently being proposed.

Additionally, Airservices states that in setting prices it has regard to equity considerations: its principles dictate that prices should conform to reasonable notions of

¹²³ ICAO, in its *Policies on Charges for Airports and Air Navigation Services*, recommends, in respect of air navigation charges, that 'the weight scale should take into account, less than proportionately, the relative productive capacities of the different aircraft types concerned'. (p. 18)

¹²⁴ Airservices, similarly to other international ANSPs, already uses a formula based on the square root of MTOW for en route services.

fairness, which means that the allocation of overhead costs among customers should not be capricious.¹²⁵

As stated above, the use of a power of less than one is expected to benefit larger operators and have a very significant negative impact on smaller operators. A 500 tonne weight cap is not expected by Airservices to have a substantial impact on most user groups, due to the limited number of A380 operations available. Although equity considerations do not fall strictly within the ACCC's consideration of Airservices' prices, the ACCC notes that it does not consider that the proposed use of MTOW (industry averaging, 500 tonne cap) would result in a 'capricious' allocation of overhead costs.¹²⁶

In light of the above, the ACCC considers Airservices' basis of charges and its 500 tonne cap are reasonable approaches.

Weight-based charging going forward

The ACCC considers that Airservices should continue to review its pricing mechanisms (including the level of the cap) during the LTPA to ensure that charges reflect maximum efficiency.

While Airservices has submitted that the cap is aligned with notions of efficiency incentives, the ACCC considers that—in light of the limited number of A380 operations—the 500 tonne cap will also not affect incentives for the use of other aircraft. In light of the uncertainty surrounding the efficiencies associated with larger aircraft and the price elasticities of various users (as discussed above), it is not clear whether the 500 tonne cap is likely to result in any positive (or negative) efficiency outcomes.

However, Airservices has advised that it has reviewed whether this cap should be reduced further to include some new aircraft due to arrive soon that weigh in at 450 tonnes and noted that it expects to lower the cap over time. The ACCC considers that lowering the cap will create improved incentives for the use of larger aircraft.

In its submission, Cathay Pacific stated that it was opposed to the 500 tonne weight cap as it is 'discriminatory and introduces cross-subsidisation between operators'. The ACCC has not been provided with any information that suggests that the advantage provided by the cap to A380 aircraft is anti-competitive. Further, the ACCC notes that, as discussed above, there may be efficiencies associated with larger aircraft that Airservices is aiming to encourage through the implementation of a cap, and these efficiencies may be enhanced when Airservices lowers the cap to include other large aircraft.

¹²⁵ Airservices, *Price structure options discussion paper*, August 2008, page 47.

¹²⁶ Airservices has submitted that in proposing the prices in its LTPA, it has tried to moderate the impact of the changes through caps to prevent large price shocks. It argues that, as many users will acquire a range of services, the changes for these users will offset each other to an extent so that the overall impact is likely to be affordable. Affordability is also supported by the fact that [Airservices] charges will often represent a relatively small component of the final end-user's price (Airservices Australia, *Draft price notification*, March 2011, p. 58.).

8.4.2 Other basis of charges issues

This section considers other ‘basis of pricing’ issues included in Airservices’ proposal:

- Basis of pricing for en route services (no price changes are proposed in this LPTA)
- Charges for non-aviation ARFF call outs
- General Aviation (GA) charging.

Airservices’ position on other basis of charges issues

Airservices has provided information that it is transitioning from its current network of en route operations to four service delivery environments over the next five years: East Coast Services, Regional Services, Upper Airspace Services and Network Management Services.

It has submitted that functionally based pricing for en route services will better link service costs to service price, encouraging more efficient outcomes.

Airservices’ proposed changes to ARFF and GA charging are included at page 52 of its draft price notification.

Airservices also provided additional information to the ACCC on its proposed changes to GA charging. In particular, Airservices provided a comparison of the net cost to Airservices applying a \$500 charge free threshold versus a \$1,000 charge free threshold (table 8.3). Airservices believes the \$138,000 net cost of the proposed \$500 threshold is not material. The cost of having a \$1,000 threshold would be substantially higher, at \$605,000.

Table 8.3: Net cost of GA charge free threshold alternatives

Revenue segment	Number of aircraft	Revenue foregone	Administrative savings	Net Cost
\$0 - \$500	5 236	\$500 000	\$362 000	\$138 000
\$0 - \$1 000	5 900	\$1 000 000	\$395 000	\$605 000

Source: Airservices Australia, Response to ACCC’s additional information request, 4 April 2011.

Views of interested parties on other basis of charges issues

En route services

A number of parties responding to the ACCC’s issues paper were generally supportive of Airservices’ proposed changes and timeline. In particular:

- RAAA was content with the pricing used for en route services.

- Rex accepted the proposal and stated that it was comfortable with the timeline but noted that extensive and timely consultation with industry must be undertaken for further development.
- Qantas stated that it would support a shift towards en route charges based on the level of airspace and the services provided in that airspace.
- BARA stated that it has no issues with Airservices' proposed timeline for establishing structure of en route pricing and submitted that it is appropriate for Airservices to evaluate the differences in costs of providing en route services between functional lines.

However, some parties (for example, Emirates, IATA) expressed concerns about the proposed changes to the en-route pricing arrangements or to the proposed timing.

In particular, Emirates submitted that:

- The charging structure for en-route services imposed a competitive disadvantage and reduced investment incentives on carriers operating flights over Australia's Oceania sectors.
- A single charge results in a significant overcharge on Emirates flights over the Indian Ocean as the cost of providing en route services is far lower in the area.
- The introduction of a separate Oceanic charge should be implemented within this pricing agreement period. The proposed 5 year timeline to correct this imbalance is unreasonable.
- There should be an interim arrangement for the rebate of excess revenues to users of Oceanic sectors until a revised approach to en route charging is adopted.

IATA submitted that a charging formula for en route services based on distance or time will provide the adequate incentives to allocate capital in the most efficient manner rather than weight based charging. In respect of timing, IATA argued that the review of en route charging should be brought forward.

VAA acknowledged that there were no price increases proposed but submitted that it was concerned that savings from the removal/decommissioning of navigational aids not included in the backup network may be transferred to cross subsidise other expenditure.

Other charges (including charges for non-aviation ARFF call outs and general aviation)

All submissions received from interested parties have expressed support for the proposed charges for non-aviation ARFF call outs and rebate to customers. However, Cathay Pacific and IATA suggested that rebates should only be provided to users which are currently overcharged to cross subsidise other ARFF locations.

In respect of the proposed changes to general aviation, a number of comments were made by interested parties. In particular:

- RAAA submitted that the \$500 threshold for general aviation is seen as a positive move but argues that general aviation aircraft under 5,700 tonnes should be exempt from Airservices charges completely.
- The Qantas Group stated that it is not able to assess whether airlines are subsidising low frequency general aviation and submits that if that is the case, such cross subsidies are not desirable or reasonable.
- Cathay Pacific Airways stated that it supports the proposal in principle. However, Cathay Pacific Airways also noted that the proposal lacks a cost/benefit analysis to show that it is administratively inefficient to continue collecting these charges and if Airservices is not able to demonstrate this definitely then this proposal potentially introduces an additional level of cross-subsidisation.
- IATA submitted that the proposals imply an additional cross subsidy and cannot support such a move unless Airservices can provide a cost-benefit analysis supporting this proposal.

ACCC's views on other basis of charges issues

In respect of the proposed changes to en-route pricing arrangements, the ACCC notes that there are no price increases being proposed for this LPTA. However, the ACCC notes that there was a level of support for the en route proposal from interested parties, although some parties had concerns about elements of the proposal (for example, Emirates suggested that a separate Oceanic charge should be implemented) and timing. The ACCC agrees with Airservices that functionally based pricing for en route services will better link service costs to service price, encouraging more efficient outcomes.

The ACCC does not object to the proposed non-aviation ARFF call-out charges. The ACCC notes that, in general, submissions expressed support for the changes.

The ACCC does not object to the proposed changes to GA charges since it appears that it reduces the administrative burden associated with collecting charges that relate to 0.02 per cent of Airservices' revenue. Airservices has provided information to the ACCC on the net cost of implementing the charge free threshold and the ACCC agrees that the net cost level (\$138,000), and hence the additional level of cross-subsidy introduced, is not material.

The ACCC encourages Airservices to continue to engage with its customers on possible pricing options for all of these services. This would allow Airservices to be in a position to adjust its pricing mechanisms to maximise efficiency when opportunities arise or if there is a change in its operating environment.

8.5 Timing of recovery of capital costs

8.5.1 Airservices' position on timing of recovery of capital costs

Airservices submitted that the draft price proposal incorporates an element of prefunding of capital expenditure projects. Airservices stated that prefunding of capital projects enables it to smooth prices over a period of time, and is therefore in the interests of longer term price certainty, which is one of the outcomes the long term

pricing arrangements seek to achieve. Airservices submitted that incorporating the costs of specific projects on a year to year basis would have the effect of ‘ratcheting up’ prices and see a return to the yearly price re-setting model.¹²⁷

Airservices submitted that the current proposal does not incorporate significant prefunding, and that commissioning of capital expenditure is expected to occur within 18 months of spending. Airservices stated that this included the upgrade of the ATC (air traffic control) system, which it expects to be progressively commissioned as the components of the system are implemented.¹²⁸

8.5.2 Views of interested parties on timing of recovery of capital costs

Several stakeholders expressed concerns about prefunding of capital projects – both direct prefunding, or prefunding that can occur as a result of project delays.

Qantas did not support the direct prefunding of rolling programs incorporated in the ATM Future Systems project. In addition, Qantas argued that the costs of new ARFF services should not be introduced prior to their actual implementation.

IATA and VAA were also strongly opposed to funding services ahead of their implementation. In addition, IATA did not support the depreciation of non-commissioned assets as well as the inclusion of the cost of capital assets under construction. It argued that the costs of capital of assets under construction should be capitalised and depreciated over the life of the asset.

BARA preferred an approach where prices are fixed for a five year period, rather than year to year adjustment of prices. However, BARA also noted the importance of continued consultation with industry regarding the delivery of its capital program. BARA considered that by addressing lack of transparency for capital expenditure over time it would improve industry confidence about prudence of capital expenditure.

Rex submitted that it was content with the proposal based on the advice that significant prefunding of capital expenditure is not included. Rex noted that significant prefunding would add to ticket prices in advance and may affect demand.

8.5.3 ACCC’s views on timing of recovery of capital costs

The ACCC acknowledges stakeholders’ concerns relating to the prefunding of capital projects, and the associated issues relating to ‘equity over time’, given the possibility that current users may fund projects from which they do not receive any benefit and future users conversely may receive benefits of infrastructure that they have not contributed to. Further, the ACCC recognises that capital projects that expand, upgrade or provide new services, will have different implications for equity over time than those projects that replace existing services.

¹²⁷ Airservices Australia, *Draft price notification*, March 2011, p. 68.

¹²⁸ Airservices Australia, *Draft price notification*, March 2011, p. 68.

Consistent with the ACCC's approach to the assessment of the draft price notification as described above, its focus in relation to the timing of recovery of capital projects will be on the prudence of the method of funding, and whether the amounts that are recovered from users by Airservices do not exceed the costs.

In this context, the ACCC has some practical concerns about prefunding given that Airservices' building block model may not be transparent to users. However, the ACCC is willing to accept that depending on the period and level of prefunding, there may not be a material impact on the level of cost recovery from this perspective.

The ACCC notes Airservices' submission that the commissioning is to occur within 18 months from when costs begin to be recovered from users. The ACCC is willing to accept that this is not an unreasonable period of prefunding, given the nature of the industry. Further, Airservices provided the ACCC with confidential information which showed that the level of prefunding embodied within its draft price notification does not result in a significant increase in Airservices' cost recovery in those periods. On this basis, the ACCC is willing to accept the level of prefunding embodied within Airservices' draft price notification.

Further, the risk sharing arrangements will go some way to protecting users in the case of delays in spending, although the ACCC considers there is scope to balance the risks more appropriately and to improve the transparency and accountability for the delivery of capital projects (see section 7.4).

The ACCC notes also that alternatives to prefunding are available, such as seeking funds from the market and incorporating costs into prices once assets have been commissioned. That said, any method of funding capital projects (even over a shorter time period) is likely to have associated issues of equity over time for users depending on the expected life of infrastructure, and movement of firms into and out of the industry.

The ACCC would encourage Airservices to consider the costs and benefits of alternative methods of funding in terms of overall costs, and impact on prices over time, to ensure that the most prudent method of funding capital projects is implemented.

9 The ACCC's preliminary view

The ACCC's discretion under the provisions of Part VIIA of the CCA is essentially limited to objecting or not objecting to the proposed price notifications put before it (see section 3.1).

The Australian Competition and Consumer Commission's (ACCC's) preliminary view is to object to Airservices Australia's (Airservices') proposed price increases for TN and ARFF services. Charges for en route services were proposed to remain unchanged.

The ACCC is concerned that Airservices has not undertaken adequate consultation to ensure that its proposed capital expenditure program is prudent and efficient. Further, the ACCC considers that there is scope for Airservices to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets. The

ACCC also considers that the methodology applied by Airservices in estimating the nominal risk-free rate and cost of debt margin has resulted in a proposed rate of return that is currently too high. This means that Airservices would over-recover its required revenue based on its proposed prices.

The ACCC considers that if Airservices can address these matters prior to submitting its formal price notification, then the ACCC would be minded to not object.

Appendix A: Airservices Australia's current and proposed prices and price structure

A.1 En route services

Charging formula for en route services:

- For IFR aircraft with an MTOW of 20 tonnes or more:

$$price \times \frac{distance}{100} \times \sqrt{MTOW}$$

- For IFR aircraft with an MTOW up to 20 tonnes:

$$price \times \frac{distance}{100} \times MTOW$$

Table A1: Airservices' current and proposed prices for en route services

Current price	En route service	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
\$4.18	20 tonnes or more	\$4.18	\$4.18	\$4.18	\$4.18	\$4.18
\$0.93	Up to 20 tonnes	\$0.93	\$0.93	\$0.93	\$0.93	\$0.93

A.2 TN services

Charging formula for TN services:

- For all aircraft:

$$price_{location} \times MTOW$$

Note: MTOW shall not exceed 500 tonnes.

Table A2: Airservices' current and proposed prices for TN services

Current price	TN service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
\$11.43	Adelaide	\$11.66	\$11.83	\$11.95	\$12.01	\$12.07
\$5.83	Brisbane	\$6.12	\$6.18	\$6.21	\$6.21	\$6.21
\$10.95	Cairns	\$11.50	\$11.90	\$12.32	\$12.75	\$13.07
\$12.66	Canberra	\$12.28	\$12.03	\$11.91	\$11.80	\$11.80
\$10.82	Coolangatta	\$10.28	\$9.77	\$9.28	\$8.81	\$8.50
\$5.06	Melbourne	\$5.31	\$5.50	\$5.51	\$5.53	\$5.54

Current price	TN service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
\$8.63	Perth	\$8.20	\$8.03	\$7.87	\$7.72	\$7.70
\$5.57	Sydney	\$5.58	\$5.59	\$5.60	\$5.61	\$5.62
\$12.69	Albury	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Alice springs	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$5.49	Avalon	\$4.70	\$4.86	\$5.03	\$5.21	\$5.39
\$12.69	Broome	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Coffs Harbour	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$9.20	Hamilton Island	\$9.66	\$10.00	\$10.35	\$10.71	\$11.09
\$9.54	Hobart	\$9.64	\$9.73	\$9.78	\$9.78	\$9.78
\$12.69	Karratha	\$13.32	\$13.79	\$14.27	\$14.77	\$15.07
\$12.22	Launceston	\$12.83	\$13.28	\$13.74	\$14.23	\$14.72
\$12.69	Mackay	\$12.44	\$12.31	\$12.19	\$12.07	\$11.95
\$12.69	Maroochydore	\$13.32	\$13.79	\$14.14	\$14.28	\$14.42
\$12.69	Rockhampton	\$12.94	\$13.20	\$13.33	\$13.47	\$13.60
\$12.69	Tamworth	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Archerfield	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Bankstown	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Camden	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Essendon	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Jandakot	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Moorabbin	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$12.69	Parafield	\$13.32	\$13.79	\$14.27	\$14.77	\$15.29
\$2.26	Darwin	\$2.15	\$2.04	\$1.94	\$1.84	\$1.75
\$2.94	Townsville	\$2.79	\$2.65	\$2.52	\$2.39	\$2.27

A.3 ARFF services

Charging formula for ARFF services:

- For all aircraft greater than 15.1 tonnes and target aircraft between 5.7 and 15.1 tonnes:

$$price_{category,location} \times MTOW$$

Note: MTWO shall not exceed 500 tonnes.

Table A3: Airservices' current and proposed prices for ARFF services

Current price	ARFF service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
Category 6 aircraft and below						
\$1.81	Brisbane	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Melbourne	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Sydney	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Perth	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Adelaide	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Cairns	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Darwin	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Gold Coast	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Canberra	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Hobart	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Karratha	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Townsville	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Alice Springs	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Avalon	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Ayres Rock	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Broome	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Hamilton Island	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Launceston	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Mackay	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Rockhampton	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
\$1.81	Sunshine Coast	\$1.99	\$2.19	\$2.33	\$2.39	\$2.41
Category 7 aircraft						
\$1.93	Brisbane	\$2.12	\$2.34	\$2.45	\$2.57	\$2.57
\$1.89	Melbourne	\$2.08	\$2.29	\$2.40	\$2.52	\$2.52
\$1.86	Sydney	\$2.05	\$2.25	\$2.36	\$2.48	\$2.48
\$2.01	Perth	\$2.21	\$2.43	\$2.61	\$2.75	\$2.81
\$2.33	Adelaide	\$2.56	\$2.82	\$2.96	\$3.11	\$3.26
\$2.29	Cairns	\$2.52	\$2.77	\$3.05	\$3.35	\$3.69
\$4.01	Coolangatta	\$3.97	\$3.93	\$3.89	\$3.85	\$3.79
\$3.39	Darwin	\$3.73	\$4.10	\$4.51	\$4.96	\$5.46
\$7.91	Canberra	\$8.31	\$8.51	\$8.73	\$8.94	\$9.08
\$6.73	Hobart	\$7.40	\$8.14	\$8.96	\$9.85	\$10.00

Current price	ARFF service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
\$7.40	Karratha	\$7.77	\$7.96	\$8.16	\$8.37	\$8.37
\$8.47	Townsville	\$9.32	\$10.25	\$11.27	\$12.40	\$13.64
Category 8 aircraft						
\$2.62	Brisbane	\$2.88	\$3.17	\$3.33	\$3.41	\$3.41
\$2.29	Melbourne	\$2.52	\$2.77	\$2.91	\$2.98	\$3.01
\$2.08	Sydney	\$2.29	\$2.52	\$2.64	\$2.64	\$2.64
\$3.01	Perth	\$3.31	\$3.64	\$4.01	\$4.41	\$4.85
\$9.12	Adelaide	\$8.12	\$7.22	\$6.50	\$5.85	\$5.27
\$4.76	Cairns	\$5.24	\$5.76	\$6.34	\$6.97	\$7.67
\$4.01	Coolangatta	\$4.41	\$4.85	\$5.34	\$5.87	\$6.46
\$16.06	Darwin	\$17.67	\$19.43	\$20.40	\$21.42	\$21.75
Category 9 and 10 aircraft						
\$3.70	Brisbane	\$4.16	\$4.58	\$5.04	\$5.54	\$6.09
\$3.03	Melbourne	\$3.41	\$3.75	\$4.12	\$4.54	\$4.99
\$2.45	Sydney	\$2.76	\$3.03	\$3.34	\$3.67	\$3.67
\$5.08	Perth	\$5.72	\$6.29	\$6.92	\$7.61	\$8.37

Appendix B: List of submissions

The ACCC received submissions on Airservices' draft notification from the following parties:

- Aircraft Owners and Pilots Association of Australia (AOPA)
- Air New Zealand
- Australian Regional Tourism Network (ARTN)
- Board of Airline Representatives of Australia (BARA)
- Cathay Pacific Airways
- Emirates
- Gold Coast Airport
- International Air Transport Association (IATA)
- Qantas Group (comprised of Qantas, Jetstar and QantasLink)
- Regional Aviation Association of Australia (RAAA)
- Regional Express (REX)
- Singapore Airlines
- United Continental Holdings
- Virgin Australia Group of Airlines (VAA)

The submissions are available on the ACCC's website at www.accc.gov.au/aviation.¹²⁹

¹²⁹ www.accc.gov.au/aviation > Airservices Australia > Price notifications > Long-term price notification 2011 > ACCC issues paper and submissions received.

Appendix C: About Airservices Australia

Airservices was established under the *Air Services Act 1995* (AS Act). It is a monopoly provider of air traffic management and aviation rescue and fire fighting services.

In performing its functions, Airservices is required by section 9 of the AS Act to regard the safety of air navigation as its most important consideration. Under section 10, Airservices is, where appropriate, required to consult with government, commercial, industrial, consumer and other relevant bodies and organisations (including the International Civil Aviation Organization (ICAO) and bodies representing the aviation industry).

C.1 Ministerial role in price setting

Under section 53 of the AS Act, the Board of Airservices may set charges for services and facilities. Under section 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.

C.2 Corporate plan

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

- the need for high standards of aviation safety
- the known objectives and policies of the Commonwealth Government
- any directions made by the Minister under section 16
- any payments made by the Commonwealth to Airservices to fund its search and rescue services
- 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)
- the expectation of the government that Airservices will pay a reasonable dividend
- any other commercial considerations that may be appropriate.

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

C.3 Minister's directions

Under section 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 subsection 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.

C.4 CASA's role in determining services to be provided

The Civil Aviation Safety Authority (CASA), responsible to the Minister for Infrastructure and Transport, is the regulatory agency responsible for safety. In particular, CASA is responsible for matters such as the classification of airspace and the designation of air routes.

CASA regulations require that services are provided when passenger or aircraft movements exceed certain thresholds.

Appendix D: The ACCC's approach to the interpretation of the statutory criteria

In exercising its powers and performing its functions, section 95G(7) of the CCA requires the ACCC to have particular regard to the need to:

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

In assessing the price notification against the statutory criteria, the ACCC has interpreted the criteria in subsections 95G(7)(a) and (b) as seeking to promote economically efficient investment and employment throughout the economy. This is broadly consistent with the objectives outlined by the Government for pricing infrastructure services under the national access regime.

Economic efficiency encompasses the following elements:

- productive efficiency, which is achieved when firms have the appropriate incentives to produce goods or services at least cost, and production activities are distributed between firms in a manner that minimises industry-wide costs.
- allocative efficiency, which is achieved when firms employ resources to produce goods and services that provide the maximum benefit to society.
- dynamic efficiency, which is achieved when firms have appropriate incentives to invest, innovate and improve the range and quality of goods and services, increase productivity and reduce costs over time.

In an open and competitive economy, efficient provision of services underpins investment and employment opportunities. Welfare enhancing investment and employment in the national economy will be promoted when firms produce goods or services at least cost and charge prices that correspond as closely as possible to competitive levels. Although a competitive benchmark may be lacking in industries subject to prices surveillance, economically efficient prices would, as in competitive areas, reflect least-cost production and include profit margins reflecting a return on capital commensurate with the risks faced by the firm.

Prices above efficient levels result in a loss of allocative efficiency as they discourage some marginal purchases which would have had a value to the purchaser above the cost of supply. As excessive prices are passed on in higher costs for other industries using the services, they lead to lower profits and potentially a loss of investment and employment opportunity in the competitive sectors of the economy.

Accordingly, the ACCC considers that the criteria in subsections 95G(7) will generally be met by economically efficient prices which reflect:

- an efficient cost base
- a reasonable rate of return on capital.

Including a reasonable rate of return on capital addresses the criterion in paragraph 95G(7)(a) by providing incentives to maintain profitable investment. At the same time, discouraging a declared firm from charging prices based on profits greater than the reasonable rate of return, as per criterion in paragraph 95G(7)(b), addresses issues relating to market power that the firm may have in the market for notified goods and services.

With regard to the criterion in paragraph 95G(7)(c), in assessing a price notification the ACCC will usually treat the level of wages and conditions as part of its broader concern for an efficient cost base.

As discussed in section 6 of this document, there are also a range of non-commercial incentives that influence Airservices' incentives and behaviour, and these will be taken into account in assessing the price notification where applicable.

More detailed information on the ACCC's approach to the interpretation of the statutory criteria is contained in the ACCC's *Statement of regulatory approach to assessing price notifications* (June 2009), which is available on the ACCC's website at: www.accc.gov.au.¹³⁰

¹³⁰ www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.