1. *Activity forecasts*

- Several submissions raised concerns about the activity forecasts initially proposed by Airservices. In response Airservices has adjusted its forecasts for Cairns and Gold Coast Airport.
    - Has Airservices reviewed its activity forecasts for other airports, including Adelaide airport (which submitted that its activity forecast should be higher than the forecast proposed by Airservices)?

We have reviewed the Adelaide forecast and believe that it is still largely in line with the IATA forecast. For 2010/11, the IATA forecast of 2.335m tonnes compares to our current internal forecasting of 2.348m tonnes.

In comparison, our current internal forecast for Cairns in 2010/11 is 1.488m tonnes which is materially higher than the IATA forecast of 1.357m tonnes and our current internal forecast for Gold Coast in 2010/11 is 1.650m tonnes which is materially higher than the IATA forecast of 1.543m tonnes.

It is worth noting again that forecasting is challenging in the aviation environment. The current internal forecasts do not reflect the expected slowdown in Japanese tourist numbers following the earthquakes, the recent Qantas announcement on 30 March to reduce previously advised capacity growth nor Jetstar pulling out significant capacity in Cairns.

2. *Building Block Model*

2.1 Return on assets

- In Airservices Statement of Intent (SOI) provided to the Minister of Infrastructure and Transport in November 2008, a 'key result area' is 'the achievement of a reasonable return on fixed assets of 20% for 2008-09'. The SOI appears to refer to a Corporate Plan that covers the 2008-13 period. We note that the Corporate Plan covering 2010-15 does not refer to a specific number.
    - Is it the case that Airservices is no longer targeting a return on fixed assets of 20%?

The 2008-13 Corporate Plan referenced a return on assets of 20% in 2008/09 for Air Navigation Services and a total return on assets (including ARFF services) of 19%. This return was largely an outcome of strong airways activity growth and not an explicit management target. On the assumption that a new pricing agreement would be struck in 2009/10 and prices would be reset, these returns were targeted to reduce toward our regulated weighted average cost of capital and reach 9% in 2012/13.

Our discussions with the Department of Infrastructure in the 2010 Plan and the 2011 Plan we are currently developing is targeting a return of between 9% and 10% which is consistent with our current forecast weighted average cost of capital.

2.2 Operating costs

- Airservices claims that the cost of contributing to its defined benefit superannuation scheme was not passed onto users.
    - How can Airservices demonstrate this?
    - What was the implication for Airservices' profit as a result of this decision?

The normal annual costs of contributing to our defined benefit fund were included in the last pricing arrangement. However, additional cash injections of $20.3m in 2009 and $10m in 2010 to meet prudential requirements based on vested benefits in the fund have not been sought to be rolled forward and recovered in this next agreement. In addition, there is a continuing risk that additional top ups in excess of normal

contributions will be required again in the future though this has not been factored into the forecast operating costs given the difficulty in predicting fund returns from investment.

These additional injections were required as a direct result of significant asset decline in the equity markets which have yet to recover and which will put a continued strain on funding requirements going forward should a longer term recovery not occur.

- To what extent do CASA requirements (or requirements of other regulatory bodies) dictate the level of operating costs for each of the declared services? To what extent does Airservices have discretion in relation to how it meets regulatory requirements?

  CASA typically sets out the requirements in a number of ways, including outcomes (e.g. a fire vehicle needs to accelerate at a certain rate and reach a certain point in a particular time period with certain staff and materials on board etc.) and/or prescription in terms of technology, the number of staff required to be on duty while services are being provided, the amount of consumables (e.g. water, foam) to be available etc. The specifics for a service are set out in safety reviews that CASA undertakes.

  A number of examples of these aeronautical studies can be found on the CASA website at:

  http://www.casa.gov.au/scripts/nc.dll?WCMS:STANDARD::pc=PC_90465

  A copy of the study relating to the recent GAAP to Class D airspace change is at:

  http://www.casa.gov.au/wcmswr/_assets/main/oar/download/gaap_report_v2.pdf

  Standards applicable to the provision of Aerodrome Rescue and Fire Fighting Services (ARFF) can be found at:

  http://www.casa.gov.au/scripts/nc.dll?WCMS:STANDARD::pc=PC_91021

- Airservices refers to the allocation between regulated and non-regulated services. Are the costs disclosed in the proposal for regulated services only?

  The information, costs and revenues included in the proposal only relates to regulated services. It does not include costs, or revenues relating to non-regulating services, nor the common costs attributed to them. In line with our previous notifications, these are managed through a dual till accounting arrangement.

- Has Airservices addressed British Airways request for “a breakdown [of Airservices’] employee numbers, split by Air Traffic Control Officers (“ATCOs”), support staff and administration staff, again split by location and/or service”?

  Airservices has provided members of the Pricing Consultative Committee with information on operational staff (both Air Traffic Controllers and Aviation Rescue & Fire Fighting) by service and by location. We provided the ACCC a copy of this information on the 7th of March and this information was also provided to British Airways.

  The support and administrative staff are not directly attributable to specific services and locations. These staff are costed to internal processes or assets they support. These are then allocated to services and locations using activity drivers or the assets that support these services and/or locations. We have provided further clarification of this to the PCC and British Airways by explaining that the support and admin staff at a location service more than that location. As an example, for a maintenance depot at a particular airport, the depot costs (including staff) are allocated to the assets they are

maintaining across their geographic region based on time and materials logged against those assets and these are then attributed to the services and locations the asset support.

- Has Airservices considered the Qantas Group's request for "more initiatives where fire fighting staff are utilised to improve the efficiency and functionality of [Airservices]. For example, that fire fighting staff become multi skilled and perform complementary Airport, Airservices or community functions which are flexible enough to not compromise CASA and airfield requirements"?

  Aviation Rescue & Fire Fighting staff already perform other duties where they do not interfere with their regulatory obligations. These include fire safety training for airlines, fire hydrant and building inspections and first aid courses.

  To ensure these duties do not disrupt any regulated services a number of these duties are often performed on overtime. All revenues and costs associated with these tasks are offset against the cost of regulatory activities.

  We continue to explore opportunities, however, under the requirements to have these staff ready to respond to any location on the airport within 3 minutes leaves few opportunities to multi-skill staff without downgrading the ARFF category of the airport.

2.3 Capital expenditure

- Airservices submits that prefunding is inevitable in a LTPA to ensure smooth prices. Some stakeholders have expressed concerns about equity over time, in that those who fund infrastructure projects may not be the same as those who eventually utilise them.
  - Has Airservices considered other methods of funding that achieve avoid prefunding, such as borrowing initially and increasing prices over the longer-term?

  There are two points here that were raised in consultation.

  The first relates to including revenues in the LTPA before the outcome is certain. That is, we need to agree funding levels for a capex program where a number of business cases have not been finalised and there are new services where there is a high probability that they will be required, but this is not certain (eg. new locations are forecast to pass the threshold for new services). In these cases, costs are forecast and included in prices.

  The alternative suggestion made during consultation was to only increase the prices when the new capex project business cases are completed or the likely new services do pass the threshold. We believe this would remove price certainty as we would need to lodge a price notification every year to ratchet up the price each year as this occurred.

  The second point relates to funding capex before it is ready for use. In this case, there was some concern from stakeholders that the prefunding may be occurring as it is for some airport infrastructure requests where the investment is being made years in advance of it being ready for use. In particular, they noted concerns about the funding for the future ATM system.

  In the proposed capex program each project (including the ATM system) is expected to have assets progressively commissioned and ready for use 12 to 18 months from when spending commenced. Given these timeframes, we consider it highly likely that those who fund the project will be the user and that an alternative method would add complexity into the process to mitigate a risk of prefunding that is likely to be less

than a year. We provided advice to some stakeholders in response to their queries indicating that the magnitude of prefunding was not material.

- To what extent do CASA requirements (or requirements of other regulatory bodies) dictate the level of capital costs for each of the declared services? To what extent does Airservices have the discretion in relation to how it meets regulatory requirements?

  As noted above, CASA may give directions that are either outcome based or prescriptive or a combination of these.

2.4 Standard Costing

- Is standard costing used to determine overall costs or rather is it a method of allocating actual costs in order to make pricing decisions?

- Does the process of standardisation raise the risk of locking in costs that may be high due to a particular time profile of asset lives or workforce profile?

Standard costing is used to allocate total costs, not calculate total costs. The standard costs applied to pricing are a product of the total unit costs for a particular expense divided by the relevant unit cost driver (e.g. number of staff).

Over a given 5 year pricing agreement standard costs will smooth out any costs that may be high at a particular time of the asset life cycle or workforce profile (eg. where a particular location has a high concentration of staff with longer than average lengths of tenure and are in the high range of salary ranges).

3. *Financial model*

- The financial model provided by Airservices contains links to other spreadsheets. Can Airservices provide those spreadsheets to the ACCC?

The financial model previously provided to the ACCC links through to 6 spreadsheets. 4 of the spreadsheets are an aggregation of data contained in two main working spreadsheets and therefore have not been provided. A copy of the two main working spreadsheets which drive the model have been attached to this email, these include Building Block Prices – ACCC.xls and SUM SLC – ACCC.xls.

Building Block Prices – ACCC.xls – aggregates service costs and asset values to determine allowable revenue levels. It then applies airways activity forecasts for each service to calculate service prices.

SUM SLC – ACCC.xls – details the composition of service costs and asset values for each service for each of the 5 years covered under this price notification.

These are somewhat complex in how they connect and it would be worthwhile for us to sit down with your team to walk them through each spreadsheet.

- Can Airservices provide a reconciliation of the opening asset base for 2011 with the closing asset base for 2009 as modelled in the 2004 LPTA?

Airservices opening asset base has been calculated using i) 2004 opening asset values, useful lives and depreciation for assets in existence at the time of the 2004 Hymans asset review; ii) actual capital expenditure and depreciation for the assets created between 2004 and 2010; and iii) forecast capital expenditure and depreciation for capital expenditure for 2010/11 to 2015/16.

This approach ensures that original valuations that were in existence in the 2004 LTPA asset review have been carried through to the 2011 price notification and cost based valuations are used for the assets actually created after 2004. Accounting adjustments for asset revaluations (particularly upward land and building revaluations due to market indexation) are not passed onto Industry through our charges.

4. *Pricing and structure of prices*

- ICAO and IATA's international policy provides guidelines for air navigation service providers to observe when setting user charges.
    - What is Airservices' internal approach to addressing international policy when setting prices?
    - To what extent is current international policy reflected in Airservices' draft price notification?

  Airservices largely complies with international policy that is set out in ICAO'S Policies on Charges for Airports and Air Navigation Services document and can be found at:

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

  The current charges for TN and ARFF have been in direct proportion to MTOW which we are addressing through this notification.

4.1 En route charges

- Airservices aims to adopt 'functionality based' pricing but not in the next five years. What are the efficiency implications for Airservices and airlines of 'functionality based' pricing? In general, what is required for Airservices to adopt such pricing?

  Functionally based pricing for enroute services will better link service costs to service price, encouraging more efficient outcomes.

  Airservices is transitioning from its current network of enroute operations to four service delivery environments over the next five years: East Coast Services, Regional Services, Upper Airspace Services and Network Management Services. To adopt this new service delivery environment, Airservices has been pursuing some reform in relation to airspace structure, air traffic controller rating standards and how the ATC group is organised. Ultimately, this will increase ATC staff flexibility and efficiency, allowing staff to operate more widely within the different service delivery functions. This will help to optimise staff rosters to meet user demand and improve how those environments are managed to provide operational benefits to the users of those environments. Upgrades to our air traffic management system across the next five years will also facilitate this transition.

4.2 Weight as the basis of charging

- In explaining the rationale for using the average MTOW, the draft price notification states there is no clear relationship between MTOW and Airservices' cost of providing the service.
    - Is MTOW used as a proxy for capacity to pay?
    - If so, what is the rationale for weight capping the A380? Why has Airservices chosen to not continue pricing according to weight to capture the additional revenue?
    - In relation to the A380 cap, Airservices notes that international policy discourages the direct relationship between aircraft weight and charges.

Could you explain why Airservices has observed this policy principle in relation only to the A380?

- Airservices also states that the price cap takes into account greater efficiencies associated with the larger aircraft. Could you provide more information about the efficiencies that the A380 generates and how these align with Airservices' pricing principles or broader objectives?

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.

While noting this, the International Civil Aviation Organisation (ICAO) recommends that the charges should not be in direct proportion to MTOW. 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.

In modelling these scenarios, we found that applying a power had a very significant negative impact on smaller operators while larger operators benefited significantly. Alternatively, we found that a weight cap could be introduced without a significant impact on any particular operator given the limited number of A380 operations currently in service.

Our estimated savings to aircraft over 500tonnes that has been recovered across all other operators is $2m - $4m per annum. This assumes some growth in A380 operations with the introduction of A380 operations projected to occur in Brisbane and Perth in 2014 and 2016.

At the request of a number of international operators we reviewed whether this cap should reduced further to include some new aircraft due to arrive soon that weigh in at 450tonnes. The effect of lowering the cap was to give a large price reduction to the A380 and create a significant advantage.

In transition, we would expect to lower this cap over time.

In relation to the efficiencies of the aircraft we have considered whether our charging should provide incentives for efficient operations in line with obligations under our Act requiring us to minimise the impact of aircraft operations on the environment. 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 our pricing objectives.

In this proposal the main driver is the removal of pure proportional charging, while we have noted that the cap is also aligned with notions of efficiency incentives.

4.3. Cross-subsidies

- What is Airservices' rationale for the timing and magnitude of the reduction in the cross subsidy from en route to ARFF and regional TN services? Aside from price stability, what considerations has Airservices made in developing the proposed price path?

We received very strong feedback from regional and GA operators that the TN price increases in the previous LTPA were not sustainable into this arrangement and that a rate correlated with inflation could be sustained without significant dislocation.

In the case of ARFF price increases, a number of large operators expressed concern at the rate of increase in the December proposal. As a consequence, we have reduced the rate of increase in this draft notification.

- In the previous LTPA, Airservices estimated that over the period the en route subsidy would reduce from 35 cents to 10 cents on a per passenger basis – is there an equivalent estimation of the reduction in those terms for the period covered by the current draft notification?

  In total the overall level of the enroute price subsidy drops from $0.33 per tonne in 2012 to $0.07 in 2016 per tonne.

- Are there any specific obstacles to funding any ARFF or regional TN shortfalls using any other mechanism (eg. reduced dividend to government)?

  We are not aware of any other mechanisms being available to fund these shortfalls and are not sure what a reduction in dividends would achieve.

  Our obligation under our Act is to earn a reasonable return on assets which we have taken to be the equivalent of earning the weighted average cost of capital agreed through this pricing agreement.

  We think it is prudent to target reasonable returns to ensure there are the right incentives for appropriate long term investment in infrastructure to support a safe and sustainable industry.

  It is also worth noting that in our Corporate Plan over this time period we have a reduced dividend payout ratio to Government to provide a higher level of equity funding to pay for the Capital Investment Program that is to be delivered as part of this pricing proposal.

4.4 Basin pricing

- In the ACCC's decision on the previous LTPA, it accepted the concept of basin pricing and recognised the difficulty of quantifying the effects of any demand interdependencies, but encouraged Airservices to do more work to 'provide the order of magnitude of the various interactions by capital city basin and also indicate the order of magnitude of the price adjustments implied'. Has Airservices estimated these?

  As noted in our paper on page 20 of our draft price notification the operation of secondary airports in capital city basins have a significant positive impact on reducing congestion and improving safety at major basin airports. Operationally and procedurally there are significant air traffic control interdependencies across the services operating into and out of basin airports.

  As noted on Table 16, page 44, of our Draft notification, prices at Major capital city basin airports have been increased by between 5% to 20% to fund secondary capital city basin airports.

Table 16 – Capital city port price contribution to closely located general aviation ports

Service	2011-12	2012-13	2013-14	2014-15	2015-16
Adelaide	19.7%	18.7%	19.1%	20.0%	20.0%
Brisbane	5.7%	5.3%	6.1%	8.0%	8.9%
Melbourne	14.4%	13.0%	13.0%	14.6%	15.4%
Perth	18.5%	14.9%	13.1%	13.3%	14.4%
Sydney	11.4%	9.2%	8.5%	9.3%	8.9%

The table below expresses this percentage contribution to secondary basin airports in pricing terms.

Service	2011-12	2012-13	2013-14	2014-15	2015-16
Adelaide	$1.91	$1.86	$1.91	$2.00	$2.01
Brisbane	$0.33	$0.31	$0.36	$0.46	$0.51
Melbourne	$0.67	$0.63	$0.63	$0.71	$0.74
Perth	$1.28	$1.04	$0.91	$0.91	$0.97
Sydney	$0.57	$0.47	$0.44	$0.48	$0.46

- Has Airservices considered the Qantas Group's suggestion that the basin in Brisbane should be expanded to include the Gold Coast and Sunshine Coast and the Melbourne basin should include Avalon Airport?

  Basin pricing recognises the interdependencies between major capital city airports and secondary capital city airports. Unlike Archerfield, Essendon and Moorabbin ATC services at airports such as Gold Coast, Sunshine Coast and Avalon were established to support growth in regular passenger transport operations. Because of the nature of operations at these ports, it is argued that places like Gold Coast and Sunshine Coast compete with each other and Brisbane. Including these airports in the basin could potentially artificially impact airport competitiveness.

  In contrast, because of the nature of operations at secondary capital city airports like Archerfield, they can not compete with their major capital city basin counterpart and are unable to effectively service regular passenger transport operations.

5. *Service provided*

- The Airservices submission (pp.58-9) refers to user comments (including from Cairns airport and the Government of South Australia) that suggest there is congestion at higher volume airports.
  - Is Airservices aware of the congestion referred to? If so, what in Airservices view is the likely cause of such congestion and which airports are affected?
  - To what extent, if any does a capacity limitation in any systems provided by Airservices contribute to congestion?

  There are a few of points here worth noting 1) that Airservices prices are a relatively small part of an airlines cost base and in themselves will not have an impact on demand and therefore any material impact on congestion 2) we believe that demand is inelastic to Airservices prices at Sydney, Melbourne and Brisbane, and given growth in activity over the last five years while prices have risen in other locations, the elasticity is relatively inelastic at locations such as Cairns and Adelaide and 3) the airports of Brisbane and Melbourne are not currently capacity constrained and 4) Sydney airport has existing throughput constraints merely as a consequence of curfews and noise management requirements.

- Has there been any substantial change to the non-price terms and conditions on which Airservices provides its regulated services?

  No, the terms are substantially the same.

- In the process for determining whether a new or increased level of service is required, the ACCC understands that CASA conducts a consultation process.
  - Does this process include forecasting demand for the service?
  - If so, to what extent does the forecasting take into account the effect on demand of price increases that are implied by the additional cost of the new or increased level of service?

The CASA processes as set out in CASA's Office of Airspace Regulation Operations (OAR) Manual provides information on the risk review process and the guidelines used to determine whether or not a new service, or change to a service is required. A copy of the OAR Manual can be found at:

http://www.casa.gov.au/scripts/nc.dll?WCMS:STANDARD::pc=PC_91287

In this review process, forecasts are considered and a cost/benefit analysis is undertaken.

6. *Government policy*

- What is the Commonwealth Government's current position on introducing competition to Airservices' declared services?

- Is the introduction of competition a likely prospect for any of the services provided by Airservices? What constraints might there be on a business seeking to provide services in competition with Airservices?

  The current Government policy is set out in the White Paper. There is no clear statement on the current Government's position on competition, although the absence of it being mentioned in the future plans may imply competition is not on the current 2020 agenda.

  It would be worthwhile to discuss this in more detail with the Department of Infrastructure.