SUBMISSION

in response to

Australian Competition and Consumer Commission
Preliminary View

of

Airservices Australia's
Five Year Draft Pricing Proposal

29 July 2011

The Qantas Group (comprised of Qantas Airways, Jetstar and QantasLink) welcomes the opportunity to make a submission in response to the Australian Competition and Consumer Commission's (ACCC) Preliminary View of the March 2011 draft price notification by Airservices Australia (AsA) for En-route and Terminal Navigation (TN) services and Aviation Rescue and Fire Fighting (ARFF) services to 30 June 2016.

The Qantas Group is in broad support of the ACCC's Preliminary View to object to the proposed charges in their current form.

The main issues for the Qantas Group are:

1. despite improvements AsA has not undertaken sufficient engagement or consultation with airline stakeholders in the development of their capital plan and the Qantas Group seeks a solid commitment for greater transparency;

2. accountable and more effective Key Performance Indicators (KPIs) are not yet able to demonstrate efficient and prudent expenditure;

3. better oversight of the capital plan and tighter risk sharing trigger points are needed;

4. the Qantas Group supports the changes proposed by the ACCC in relation to the Weighted Average Cost of Capital (WACC) assumptions, in particular to the cost of debt margin and nominal risk free rate; and

5. prefunding is an inequitable and unacceptable practice. 'Placeholder' funding for the Air Traffic Management (ATM) Future Systems Project should not be included in the capital plan as no details for the project are available and no element of the ATM Project is expected to be commissioned during the Long Term Pricing Agreement (LTPA).

1. <u>Capital and Operational Expenditure</u>

The Qantas Group agrees with the ACCC that AsA has taken some steps since its 2004/ 2005 LTPA to further establish consultation processes with its users. However, the level of consultation to date cannot be described as extensive enough for stakeholders such as the Qantas Group to provide informed comments on a proposed plan or, to establish whether the capital expenditure program is prudent and efficient. A process is yet to be established for ongoing review of the capital plan to an acceptable level of clarity that would enable users to validate and endorse the program.

On the basis of the ACCC's preliminary view, the ACCC should only accept AsA's final pricing for LTPA on condition that AsA agrees to include the following specific undertakings for consultation with users:

a) visibility of business cases for major projects (greater than $10 million) at the appropriate project conception stage in order for users to be engaged much earlier in the option generating process prior to decision making;

b) presentation of business cases for major projects at the quarterly Pricing Consultation Committee (PCC) meeting for endorsement. Business cases should include expected capital and operational costs, all types of benefits (quantitative and qualitative), timing, justifications and assumptions. Business cases should as a minimum be provided to PCC members for review 10 working days prior to the meeting.

c) presentation of a major project's business case to ensure that benefits are identified and realised as were planned for at the conception phase;

d) as part of its ongoing consultation, AsA must provide full management reporting of the capital and operational expenditure program on a quarterly basis to the PCC members at least 10 working days prior to the meeting. Such reporting is required by airlines to monitor capital management (at a specific project level and overall) and monitor how it relates to the determined charges set by the pricing models;

e) formally respond to the Qantas Group's requests for further information on the capital expenditure program posed to AsA in January 2011 and consult in further detail on the outstanding items where the Qantas Group still has concerns upon receipt of the formal response; and

f) commit to provide airline users with a historical forecast and actual account of the capital expenditure, asset values and depreciation by service for the past LTPA and monitor this annually going forward as a measurable KPI in the Service Charter.

2. Performance Measurement and Monitoring

The Qantas Group supports the ACCC view that the Service Charter should be expanded to cover cost efficiency KPIs which could be used as an ongoing driver of prudent and efficient of capital expenditure and operations.

With regards to further KPIs in the Service Charter referred to in section 5.3.4 of the ACCC Preliminary View, the Qantas Group seeks from AsA a commitment and timeframe (not greater than three years) to negotiate and determine financial or pricing consequences for not achieving agreed KPIs.

3. Risk Sharing

The changes to the capital expenditure risk sharing mechanism proposed by AsA have been considered by the ACCC to be ineffective at sharing risk, driving efficiency or prudency with timing. The Qantas Group proposes capital expenditure trigger points be further reduced to thresholds of 10 per cent of agreed expenditure in a single year and less than 5 per cent of agreed capital expenditure on a cumulative basis to ensure prudent and efficient cost management practices are carried out by AsA.

The Qantas Group proposes that for any major project with a determined scope that AsA requires an increase of the total project cost by 10 percent, AsA must consult with the airlines, justify the increase (based on benefits and costs) and see approval from airlines. If such justification was not accepted AsA itself should be required to incur the additional cost. Such additional costs should also not contribute to an increased asset base for the purposes of the next LTPA.

The PCC would be the best forum for this approval process. The introduction of such measures should demonstrate appropriate governance and effective capital management.

4. WACC

The revision of the WACC calculation by the ACCC is supported by the Qantas Group, in particular the review of the nominal risk free rate and cost of debt assumptions. Given AsA is a AAA rated entity by Standard & Poor's, it is appropriate to price AsA's cost of debt in accordance with the cost of debt for other comparable AAA rated entities. The Qantas Group therefore considers the methodology proposed by the ACCC to price the cost of debt margin by taking an average of all AAA rated fixed rate bonds with remaining maturity of between four and six years and deducting the nominal risk free rate of these bonds to be fair and reasonable.

In terms of pricing the nominal risk free rate, the Qantas Group also considers it inappropriate for AsA to consider using a 10 year government bond rate given this rate is unavailable (therefore any proposed 10 year rate is an estimated extrapolation), the LTPA is for only five years and the longer tenure leads to a higher nominal risk free rate. The Qantas Group confirms that as at 26 July 2011, the 20 day average for the AUD 5 year government bond is 4.68% which is in line with the ACCC's estimate of 4.92%.

5. Prefunding and the ATM Future Systems Project

Prefunding of assets is highly inequitable and unacceptable to the Qantas Group. Prefunding requires the Qantas Group and its passengers to pay for assets which they cannot currently use and in most cases do not benefit from for an uncertain period. Prefunding disadvantages those stakeholders that have incurred costs prior to assets being commissioned, compared to other stakeholders which may avoid prefunding costs by entering the agreement after the commissioning of the assets.

The cost of prefunding is compounded when applying a WACC to the asset costs and recovering these costs during the period prior to the use of the assets. It is appropriate therefore to commence applying a charge on assets only at the time of commissioning those assets and not before.

The scope of the ATM Future Systems Project has not yet been determined, and the costs, benefits and timing for commissioning of the Project are not yet known.

It is imprudent capital management to include in AsA's capital plan a 'placeholder' figure of $190 million when no details of the Project are available and there is no plan to commission any element of the Project within the next five years. This portion of the Project constitutes 20 percent of planned capital expenditure across the five years of the LTPA and is a significant price driver.

The appropriate action is for AsA to develop the details of the Project in consultation with industry. When sufficient details are established, the Qantas Group would support AsA seeking ACCC approval for a pricing mechanism for the Project. At that time it can be determined whether any elements should be included in the 2012 - 2016 LTPA.

Conclusion

The Qantas Group submits that the ACCC should only accept AsA's final pricing for LTPA on condition that AsA incorporates the following specific undertakings:

1. commitment to provide transparency and on going monitoring of asset value, depreciation, capital and operational costs by service along with formal feedback to questions posed to AsA in January 2011;
2. commitment and timeframe to develop efficiency KPIs and mechanisms with financial consequences;
3. tighten the trigger points for capital expenditure risk sharing;
4. the cost of debt margin to be priced in accordance with the cost of debt margin for other comparable AAA rated entities and the nominal risk free rate to be based on a 5 year government bond; and
5. removal of all prefunding costs including specifically the ATM Future Systems Project which should be separated from this LTPA and negotiated in isolation.

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