QANTAS

QANTAS AIRWAYS LIMITED
ABN 16 009 661 901

SUBMISSION

TO THE

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION'S

PRELIMINARY VIEW

ON

AIRSERVICES AUSTRALIA'S
FIVE YEAR PRICING PROPOSAL

NOVEMBER 2004

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Executive Summary

Qantas Airways Limited (Qantas) is a substantial user of the services provided by Airservices Australia (AsA). Accordingly, Qantas and its customers (passengers and those transporting freight) are directly affected by the prices charged by AsA.

As stated in Qantas' submission on AsA's *Draft Notification*, while Qantas did not endorse some of the propositions put forward by AsA, it is prepared to support the pricing agreement. The agreement addresses many of the concerns raised by Qantas.

In assessing the pricing agreement, the Australian Competition and Consumer Commission (the Commission) is particularly interested in additional views from interested parties on the appropriate basis for imposing aviation rescue and fire fighting (ARFF) charges. Qantas had assumed that this issue would be addressed after suitable prices were implemented based on current charging structures.

Given the relatively short time period for comment, Qantas is not in a position to provide a considered view on appropriate charges for ARRF services. Importantly, all the necessary information is yet to be distributed by AsA to users on which to undertake an examination of the issue.

In a recent press release AsA stated that three to six months of consultation would be necessary to review the structure of charging for ARFF services. Qantas agrees that after the distribution of appropriate information within the Industry Steering Committee, a period of months will be necessary to adequately assess the appropriateness of different charging structures for ARFF services.

1 Assessment of Issues

Qantas has structured this submission on the basis of the Commission's *Preliminary View.* Accordingly, the issues discussed below are:

- consultation processes;
- risk sharing arrangements;
- operating costs;
- asset base;
- capital expenditure;
- rate of return (weighted average cost of capital (WACC));
- activity forecasts;
- structure of prices; and
- impact on users.

1.1 Consultation Processes

Qantas agrees with the Commission's recommendation that the Industry Steering Committee (ISC) and working group should continue to play an integral role in monitoring AsA's performance against its assumptions and estimates underlying the long-term price arrangements.

1.2 Risk Sharing Arrangement

The Commission has sought clarification as to whether the activity triggers for a consultative review are based on a global or location specific level. Qantas' view is that the proposed activity and capital expenditure triggers for consultation should be activated on a global level. For Qantas, this achieves an acceptable balance of risk sharing with AsA. However, Qantas also considers that there is merit in examining risk-sharing arrangements between AsA and the airlines at individual locations. In particular, it may allow for price reductions or rebates to the individual airlines contributing to strong growth at a particular location.

1.3 Operating Costs

The Commission states that the pricing agreement 'does not contain any formal or explicit incentives to minimise opex, such as would be the case if, for example, AsA's pricing was subject to a CPI-X price cap'.[1]

The process followed by the ISC and working group first involved forecasting full time equivalent employees (FTE) by service by location. This allowed for the formal incorporation of planned efficiency improvements and required increases into future FTE numbers. From this basis, other operating costs were presented and agreed upon by the ISC. This included forecast increases in wages and other on-costs.

Qantas supports any principle that will act to provide additional incentives to reduce long-term costs and encourage efficiency. Qantas believes that agreement to a known longer-term price path will provide incentive for AsA to manage costs efficiently, based on the knowledge that prices can only be changed following industry agreement after all other options have

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[1] Australian Competition and Consumer Commission (ACCC), November 2004, Preliminary View, Airservices Australia Draft Price Notification, p. 37.

been exhausted. The levels of cost within the pricing agreement are intended to provide AsA with the incentive to operate below those levels.

1.4 Asset Base

As stated in previous submissions, Qantas does not support the application of asset valuation methodologies such as depreciated optimised replacement cost (DORC) in setting prices. In this instance, Qantas did not object to the independent consultant's asset valuation on the basis that:

- as a Regulatory Asset Base (RAB) for pricing purposes is established, further re-valuations for pricing purposes are no longer necessary (and should not be permitted); and
- going forward, AsA will continue to track and update the RAB based on actual capital expenditure, depreciation and disposal of assets.

Qantas therefore supports the Commission's view that this asset base value can now be used as a reference point for future notifications, taking into account new efficient investment.

1.5 Capital Expenditure

Qantas agrees with the Commission's recommendation for AsA to clearly document the basis of its consideration of alternative technical solutions in its business case models and share this information with stakeholders. This will ensure that the safety and operational requirements of AsA's customer base drive the technological solutions to air traffic management issues.

1.6 Rate of Return

Qantas continues to express concerns over the asset betas afforded by the Commission to regulated industries. In this instance, the Commission has adopted a lower asset beta (0.55) than proposed by the consultant because it was unclear of the level of risk assumed by AsA with the inclusion of 'risk-sharing' arrangements in the five-year pricing agreement.

The Commission has not objected to the overall level of revenues sought by AsA. As such, the influence of the risk sharing arrangements should be further examined after the pricing agreement has operated for a reasonable length of time.

The Commission also considered it inappropriate to 'phase in' the WACC. The Commission has argued that 'it is inappropriate to alter the WACC unless its underlying parameters are changing.'[2]

It is noted that the proposal to phase-in the WACC was first put forward by airlines to AsA. The airlines considered it appropriate that AsA (and its Government shareholder) also bear part of the burden of not adopting full location specific pricing. It was suggested that this be incorporated into the pricing agreement by funding at least part of the under-pricing at regional/GA locations through a lower rate of return to the shareholder.

Qantas welcomes the adoption by the Commission of a lower rate of return, having previously argued that a lower asset beta should apply. On this occasion, the adoption of a "phased-in" WACC was seen as a mutually agreeable outcome in providing a mechanism to share the costs of transitioning to location-specific prices. Given the proposed mechanism provides a lower allowable revenue than otherwise might be afforded, in this instance the arrangement is

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[2] ACCC, November 2004, p. 59.

acceptable to both AsA and the airlines. The Commission's suggested changes of a lower WACC should be explored for the next pricing agreement.

1.7 Activity Forecasts

Qantas agrees with the Commission's view that AsA's general approach in deriving the growth rates of the major, regional and GA airports is appropriate. Qantas agrees that there is merit in AsA and the airlines exploring the option of entering into risk sharing arrangements at individual locations.

1.8 Structure of Prices

The Commission has raised a series of complex issues regarding the structure of AsA's pricing, including the allocation of costs between locations. Given the limited time available for comment, it is not possible to provide a comprehensive response on all of the issues raised. It will be necessary for the ISC to further consider many of the issues raised by the Commission over the term of the first pricing agreement.

Allocation of distributed costs

Qantas considers that the approach adopted in allocating distributed costs on a 'capacity to pay' basis is not consistent with either the objectives of the ISC in developing a longer-term approach to pricing or International Civil Aviation Organization (ICAO) recommendations. The approach has simply blurred the issues of what it costs to provide services at individual locations and what users are actually charged. This, in turn, has created unnecessary disagreement between AsA and the major airlines with the movement away from an accepted approach to the allocation of distributed costs.

A key objective of the ISC was to first determine the actual cost of providing terminal navigation and ARFF services at individual locations based on sound accounting principles. This approach is consistent with ICAO recommendations, which are well summarised in respect of airport charges:

> "The capacity of users to pay should not be taken into account until all costs are fully assessed and distributed on an objective basis."[3]

The use of activity based costing (ABC) generates an outcome consistent with ICAO recommendations.

Once actual costs by location were determined, AsA then distributed this information to various regional and GA airports and airlines for consideration. It is important to note that AsA's decision to alter its cost allocation methodology was in response to concerns by regional/GA operators over the increase in charges at particular locations rather than concerns over the robustness of the ABC approach.

The Commonwealth Government largely determines prices for regional and GA locations through its directions to AsA. Prices are often far below direct labour costs. As such, re-allocating distributed costs on a capacity to pay basis has not influenced the prices proposed at such locations. Instead, it has simply reduced the measured level of cross-subsidy embedded in the current pricing structures.

[3] ICAO's Policies On Charges for Airports and Air navigation Services, Sixth Edition 2001, p. 8.

No clear (causal) link

Qantas is not convinced by the Commission's statement that 'it appears to the Commission that Airservices' 'distributed' costs which have been allocated to service lines are in the nature of common costs to those services and there is no clear (causal) basis for apportioning these costs between locations.'[4] The allocation of costs by AsA to particular locations appears quite robust. As an example, there is a clear link between fire fighting training costs and the number of fire fighters at each location.

It is difficult to reconcile the Commission's current statements with the previous endorsement of the ABC approach to cost allocation by location. It appears that this decision is driven more by concerns over the ability of users to pay rather than concerns over the adequacy of the ABC approach.

It is considered essential that the Commission provide information on each identified item of distributed cost explaining why the previous ABC approach to allocation between locations is inappropriate. This analysis can then be examined and discussed by the ISC.

Price elasticities at individual airports

The Commission has argued that at Brisbane, Melbourne, Perth and Sydney, in general, for most users their demands will be relatively price inelastic. As such, it is appropriate to allocate a greater share of distributed costs to such airports. Landed tonnes are further viewed as a reasonable proxy for capacity to pay.

Qantas does not endorse the move to allocating distributed costs on a 'capacity to pay basis'. In addition, Qantas does not accept many of the propositions put forward by the Commission in applying the capacity to pay methodology to AsA's distributed costs.

Basin pricing approach

Qantas does not necessarily reject incorporating shared costs and interdependencies into pricing between airports. However, any such adjustments should be based on a robust analysis and applied on an airport by airport basis.

The approach adopted by AsA has been to first determine 'acceptable' prices and price increases at secondary airports. The difference between costs and revenues has then been transferred to the major airport for pricing purposes. This approach may or may not bear any correlation with the actual level of shared costs and interdependencies between any two airports.

Qantas therefore endorses the Commission's proposal for AsA to develop an estimation of the actual level of shared costs and interdependencies on a location specific basis. AsA can then distribute its analysis within the ISC for consideration.

Timing of price increase

Qantas supports the timing of price increases proposed by AsA.

Pricing across services and user groups

Qantas agrees with the Commission's endorsement of location-specific pricing (LSP). LSP promotes both productive efficiency and equity. AsA's pricing agreement, while involving considerable levels of cross-subsidy, largely adheres to the principle of LSP.

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[4] ACCC, November 2004, p. 76.

The Commission has concluded that terminal navigation and ARFF services at regional and GA locations are expected to recover less than incremental costs and the bundle of enroute and terminal navigation services at radar locations are expected to recover in excess of stand-alone costs.

The Commission also states that the present existence of cross-subsidy does not necessarily imply economic inefficiency.[5] That said, the Commission also states that 'prices that are not cost reflective will generally have an adverse impact on the efficiency of the resource allocation decision by AsA and its users'.[6] The Commission also supports LSP (user pays) because it can encourage productive efficiency.

Qantas did not seek to provide detailed information on the effects of the current cross-subsidy arrangements on users in its response to the Commission's *Issues Paper*. Nor is it possible to provide such an analysis in this submission given the relatively short time for comment. However, it is noted that if LSP pricing encourages productive efficiency and equity, then any move away from LSP is likely to generate productive inefficiency and inequity.

<u>The basis of Airservices' charges</u>

Qantas has long argued for a comprehensive review of AsA's charging structure. Such a review should include:

- identification of the main cost drivers associated with different services; and
- consideration of different potential charging structures against a specified set of criteria, including:
  - alignment with cost drivers and beneficiaries;
  - practicality of implementation;
  - incentive effects for investment by both AsA and users; and
  - changes in the level of payments made by different sectors of the aviation community, such as Regular Public Transport (RPT) and GA.

Again, given the relatively short time period for comment, Qantas is not in a position to provide a considered view on appropriate charges for ARFF services. Importantly, all the necessary information is yet to be distributed to users on which to undertake a comprehensive examination of the issue. Such information would include:

- the type and frequency of aircraft landings at each airport;
- aircraft statistics, such as maximum take off weight (MTOW) and seat capacity;
- total passenger numbers;
- the main cost drivers associated with ARFF services; and
- the marginal increase in costs associated with category upgrades at airports.

Without such information, it is difficult to comment on the appropriateness of different charging structures for ARRF services. Instead, only general observations can be made, which may not prove to be accurate once relevant information is available for examination. For this reason, Qantas does not endorse changing charging structures without rigorous evaluation of the various options, based on the best available information.

After the distribution of appropriate information within the ISC, a period of three to six months would be a reasonable amount of time to assess the appropriateness of different charging structures for ARFF services.

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[5] ACCC, November 2004, p. 96.
[6] ACCC, November 2004, p. 68.

1.9 Impact on Users

The Commission has argued that 'full service carriers' (of which Qantas is the only one in the domestic Australian market), have a greater flexibility in dealing with increases in input costs:

> "...in the case of 'full-service carriers', AsA's charges represent a cost that is joint across different fare classes it operates. Such a carrier (especially in the context of frequent flyer or other loyalty programs or clubs) may pass on a greater share of the joint cost to the less elastic (primarily business class) travellers."[7]

The Commission also considers that:

> "...the likely effect of the proposed price increases will not be material for passengers on the major domestic and international routes, although the effect on passengers of 'low cost' carriers is likely to be relatively greater."

Qantas strenuously rejects the Commission's view on this issue.

The intensely competitive natures of the international and domestic aviation markets mean that Qantas must continually strive to reduce its cost of doing business. Charges imposed by AsA form a significant part of Qantas' costs. Any sustained increase in these costs will put additional pressure on Qantas to extract cost synergies from elsewhere in its business.

One of the ways Qantas has recently sought to address cost pressure has been to introduce Jetstar, predominantly on less profitable routes. Jetstar is a low cost operator that focuses on point-to-point domestic leisure markets.

It is also not correct to assume that Qantas is relatively insulated from price increases and can pass on cost increases to its less price sensitive passengers. All Qantas passengers are price sensitive to varying degrees. There are very few classes of consumer that truly ignore price changes.

2 Conclusion

In its *Preliminary View* the Commission has decided not to object to the terminal navigation and enroute prices but has objected to the proposed ARFF charges.

Qantas considers that any changes to ARFF charging structures should not occur in haste. Instead, adequate information needs to be distributed within the ISC for consideration. After AsA has adequately consulted with users, a proposal can be put to the Commission for consideration.

In its assessment of the pricing agreement, the Commission has adopted various assumptions regarding the price elasticity of demand of passengers at different locations. Qantas does not agree with the Commission's methodology or application of the 'capacity to pay' approach in assessing AsA prices. The move to capacity to pay appears to be driven more by concerns over potential price increases at regional/GA locations rather than concerns over the adequacy of the ABC approach.

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[7] ACCC November 2004, p. 107.