SUBMISSION TO ACCC

AIRSERVICES AUSTRALIA DRAFT PRICE NOTIFICATION NOVEMBER 2004

INTRODUCTION

Australiawide Airlines Pty Ltd trading as Regional Express (Rex) is a regional airline operating services to 27 regional and country centres within NSW, VIC, SA, TAS and the ACT from the major hub airports of Sydney, Melbourne and Adelaide.

Rex is particularly impacted by Airservices Australia's (Airservices) pricing for Terminal Navigation (TN), Aviation Rescue and Fire-fighting (ARFF) services at the major airports.

Rex is also subject to the Enroute Charge subsidy. With the planned withdrawal of this at the end of 2004/05, the cost impact on Rex is estimated at $1.85m

ISSUES OF PRINCIPLE

Airservices is a wholly Government owned monopoly charged with the operation of navigation, aircraft separation and search and rescue services for the aviation industry.

The market within which Airservices operates is diverse. The services it provides range from high technology radar and communication systems for congested airspace at major international airports and approaches, high technology and extensively resourced ARFF services also at such airports, to very limited facilities at regional and remote locations. While there is considerable cost associated with the services at major airports in terms of TN and ARFF, there is also high demand. In a general sense unit prices at those locations should be at a level where they can be supported by users.

On the other hand services at regional and more remote locations are not necessarily low cost – for example the Albury Control Tower and the proposed Maroochydore Fire Service. The cost of operating TN and ARFF services at smaller regional locations are not supportable by demand and therefore unit prices are high.

Location specific pricing based on setting unit prices on the unit costs applying at that location leads to a wide variation in charges for the use of Airservices' facilities.

In an aviation market the size of Australia and also having regard to its geographic spread, unit prices based on unit costs and demand levels are generally high at all but Sydney where economies of scale play their part to maintain levels. Adelaide, Canberra and even Melbourne involve relatively high unit prices for TN and ARFF services.

Under the terms its charter by the Commonwealth Government, Airservices is required to act as a commercial government enterprise providing its shareholder with a commercial return. This move to "commercialise' Airservices was no doubt designed to improve the organisation's efficiency, focus on its customers and remove the potential for Government subsidy in its financial performance.

Commercialisation in the context of Airservices does not recognise this diversity nor the community service requirements involved in providing support services for the aviation industry in the same manner that such support services are provided to land based transport. This current approach to Airservices results in the application of economic rationalist principles to the provision of services where there are direct community service obligations – especially for regional Australia.

As we understand its jurisdiction, the ACCC must examine the pricing proposed by Airservices strictly in terms of economic rationalism. Such an approach must therefore restrict itself to matters such as whether:

- the costs upon which the prices are based are rational and supportable for the services provided

- the activity levels forecast are applicable and supportable

- capital investment requirements are appropriate and supportable

- the pricing methods are equitable and based on the costs of the services provided

- the rate of return is appropriate

ECONOMIC EFFICIENCY

In its submissions to Airservices and earlier to the ACCC, Rex has questioned the efficiency levels of Airservices particularly with regard manpower resources and overhead. In doing so we have commented that huge efficiencies have been achieved in the airline industry over recent years. Average fare levels have fallen dramatically and profit margins for airlines are now extremely thin. Market acceptance is now for lower and lower fare levels which have been achieved through cost reduction, efficiency increases and reduced shareholder return.

There are no such pressures on Airservices. Under the pricing regime proposed, prices levels are set simply on cost plus return. At sub section 7.1.4 and especially at (d) of that sub section, the ACCC clearly states that it is not in a position to assess whether Airservices is operating efficiently and notes substantial increases in operating expenditure and staff costs. There is also at (d) within that sub-section a discussion on incentives to place pressure on Airservices to improve efficiency, culminating in the statement that "…the ACCC considers that there are benefits in formal efficiency incentives which make transparent any gains in efficiency." Rex agrees with this assessment and view but goes further to propose that such measures are mandatory for an organisation like Airservices.

Rex recommends that without any form of efficiency measure or efficiency level targets, the price structure as proposed should be refused until such time as an appropriate independent audit is conducted of Airservices' efficiency. Such an audit should compare Airservices to an equivalent sized commercial service organisation operating in a competitive environment. Appropriate measures and target levels of performance can then be established and caps placed on price movements until the targets are met.

RATE OF RETURN

The ACCC's view that the WACC be set at 8.95 percent is still, in Rex's view, too high for an organisation such as Airservices. As a government owned organisation which has in effect taken over a large range of assets which were subsequently re-valued, a long-term, low risk activity and an organisation not subject to the rigours of commercial competition, the rate of return should be set a the lowest of levels.

The proposal to phase in the higher WACC over the five year period was simply designed to reduce the burden on the industry and impose some level of incentive to improve efficiency and productivity. Rex agrees with the ACCC that more open and transparent efficiency targets are required.

OPERATIONAL EXPENDITURE – HEAD OFFICE OVERHEADS

One of the issues identified by Rex as part of its consideration of Airservices' proposal was the lack of hard information on corporate overheads. Airservices has indicated that of total costs, 31 percent represents such Head Office overhead - 23 percent are "Specialist Distributed Costs" and 8 percent "Distributed Costs – Admin". This ration is used to allocate corporate overheads to each location for location specific pricing, Rex questions the high level of such overhead.

We recommend the ACCC examine this issue further and be satisfied that the level of corporate overhead is acceptable before agreeing to the pricing regime.

ACTIVITY FORECASTS

While Rex has enjoyed significant growth in passenger operational activity over the two years of our operation, most regional markets are now returning to levels applying before the Ansett collapse. Growth levels towards the future for regional services are considered to slow. It is our view that Airservices should be required to consider in more detail the likely activity impacts of its pricing regimes on activity at all locations other than Sydney.

In this regard we note that regional aviation is generally much more demand elastic than interstate and international air services. Regional aviation's main competitor is car transport and it is highly available in terms of supply and, at least in consumer perception, low cost.

PRICING

Rex fundamentally agrees with the pricing approach for ERC as it reflects the higher level of service and cost to larger jet aircraft. In addition, Rex notes the very low unit costs and therefore unit prices associated with ERC. A small increase in the unit price in ERC nets Airservices substantial increases in revenue. The ERC could be successfully used to cross subsidise TN and ARFF services at those locations which cannot reasonable support full cost recovery on a location specific basis.

Location Specific Pricing as proposed by Airservices for TN and ARFF at least identifies and allocates costs and prices associated with each location. However, this approach pre-supposes that the resultant price will generate the level of demand necessary to cover the costs. In regional locations this is not necessarily the case.

Rex agrees with the ACCC's assessment of the Basin Pricing approach. Rex considers this approach overly distorts the costs from pricing. In reality this has been an attempt on the part of Airservices (with some acceptance by the industry) to reduce the impact on general aviation and flying schools from the high costs of TN and ARFF at their airports. This approach has a disproportionate impact on regional carriers

Rex considers the phasing in of price increases effectively delays the inevitable. Rex recommends that the prices structure should not be approved until the recommendations set out above have been implemented.

The economic rationalist approach to non – cross subsidy and location specific pricing fails to have regard to the diverse nature of the industry and service requirements of Airservices.

Rex agrees with the ACCC that there are substantial distortions involved with ARFF services at various airports including the major international airports like Sydney where special requirements are necessary for the A380 aircraft. Rex agrees with the ACCC's recommendation that the charging structure for ARFF be reviewed before the long term pricing regime is approved.

Rex considers the ARFF charge for all operators at all major airports currently with ARFF services be based on a standard rate per tonne covering the costs up to and including a Category 6 level of service (or equivalent covering operations with say B737 / A320 aircraft which would cover the basic levels of service for all users). For those airports requiring a higher category of service, the marginal cost in providing that service over the Category 6 service be levied on all users of the larger aircraft type necessitating the higher category as a special weight based surcharge. This maintains some equity for smaller aircraft operators.

For new ARFF services (such as Maroochydore and Ayers Rock for example) or for higher category services (such as that required for the A380 in Sydney and Melbourne) charges should only be levied on the operators of the aircraft for which the ARFF service category is required. This again could be aircraft weight based.

On a similar basis Rex considers the price impact at regional locations where TN services are provided, must have regard to demand distortions. In this regard Rex also agrees with the ACCC that cross subsidization of such activities should not necessarily be eliminated. Rex considers that a degree of cross subsidy from the low unit cost ERC to TN and ARFF in certain locations is an effective method of covering costs while maintaining the level of service necessary for those locations. However, Rex also agrees that there must be suitable mechanisms in place to monitor expenditure at those locations to ensure it is not excessive.

PRICING IMPACT ON REX

Under the terms of the proposed pricing structure, the impact of Rex for TN and ARFF is as follows – based on current to Year 5.

- TN – an additional $546,600 per annum or 26.4% increase
- ARFF – an additional $160,000 per annum of 35.7% increase

For ERC, for the last full financial year Rex without the subsidy would have paid $1.85m in total for the services. For the proposed Year 5 this would reduce to $ $1.66m involving a saving of some $190,000.

The removal of the ERC subsidy and additional TN and ARFF charges as proposed in the charging regime would result in a $2.37m additional cost burden to Rex.

To put this into context, Rex made a PBT of just on $1m for 2003/04. Our PBT forecast for 2004/05 is $5.5m. The impact of these additional charges has the potential to seriously impact on Rex's viability.

LOCATION SPECIFIC PRICING AND EXPLICIT SUBSIDY

As mentioned above the regime within which Airservices has been now placed only allows pricing to be considered on an economic rationalist basis. The pricing distortions and substantial potential demand impacts which are likely to result from strict adherence to these principles through location specific pricing while retaining the community service obligations of safety regulation pose a significant problem for the industry and the community.

While Rex agrees that location specific costing and pricing is most effective and transparent, the community service obligation of safety regulation and economic / regional development must therefore generate additional considerations and actions.

Explicit subsidy is generally considered the most effective way of achieving those goals. In this case it is suggested the ACCC highlight these issues to the Government so that unintended outcomes in terms of lost services and safety regulatory implications result.

FUEL LEVY

REX understands the fuel excise levied by the Commonwealth on AVTUR yields over $100m pa in revenue. We also understand that only around half that is passed on to Airservices for the TNC subsidy ($7.0m) and CASA in funding for safety and related activities.

As this is effectively another charge on the industry it should not be re-directed to consolidated revenue but returned to the industry in the form of an appropriate contribution to the community service obligations required of Airservices where location specific prices are excessively high and have the potential to impact on demand. In other words, revenue generated from the fuel levy should be re-directed to fund an explicit subsidy.

28 November 2004