Response to Australian Competition and Consumer Commission Preliminary View of Airservices proposed draft price notification

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1 Executive Summary

On Friday 5 November 2004 the ACCC released its Preliminary View on the draft price notification of Airservices Australia (Airservices) and the accompanying submissions from stakeholders.

In short the ACCC's Preliminary View is to object to the Airservices price increases proposed for Aviation Rescue and Fire Fighting (ARFF) and not to object to the price changes proposed for Terminal Navigation (TN) and En route services. The reasoning proposed by the ACCC for objecting to the price increases for ARFF are stated below –

- The ACCC is not objecting to the overall revenue that Airservices is proposing to achieve.

- The ACCC is objecting to the basis for imposing charges for ARFF services (ie using the MTOW method). The ACCC has recommended that the method for charging for this service should be consistent with the trigger mechanisms for having to supply the service. For a service to be supplied, a port requires more than 350,000 passengers to pass through it during a financial year. The ACCC has therefore suggested that an appropriate method for charging for ARFF services is by using a per passenger rate.

As part of the Virgin Blue response to the ACCC's Preliminary View we will comment on the ACCC's recommendation for the method of charging for ARFF services.

2. Response to ACCC Preliminary Response

2.1 Consultation Process

Airservices has undertaken an extensive consultation process in developing the proposed price path.

The process commenced in August 2003 when a cross-section of international, major domestic and regional airlines, along with industry associations, representatives from airports, the general aviation industry and the ACCC were invited to an inaugural consultation meeting. This meeting agreed the framework for developing the long term pricing arrangement and established an Industry Steering Committee (ISC) to oversee the process. A smaller Working Group carrying out detailed analysis supported the ISC. Virgin Blue was represented on both committees.

The ISC agreed to adopt the ACCC's building block model to assess allowable revenues, the use of independent consultants to determine key parameters and that five years was the appropriate length for the agreement. The ISC then progressively worked through the foundation elements that underpin the proposed pricing strategy, being:

- The target return on capital;
- The capital value of existing assets;
- The forecast costs by service and location;
- The proposed capital expenditure program; and
- The forecast activity levels.

The ACCC noted that general aviation and regional airlines were not satisfied with the level of consultation as they were engaged late in the process and were not consulted on the revised proposal issued by Airservices. Virgin Blue has previously detailed its comments on the consultation process adopted by Airservices. Further, Virgin Blue agrees with the ACCC's comment that representatives from the general aviation and regional airlines should be included in future consultation processes.

2.2 Risk Sharing Arrangements

Risk sharing arrangements are outlined in the Airservices submission and reiterated in the Preliminary View of the ACCC. The risk trigger mechanism isn't meant to be an immediate rubber stamp to a required price increase. It is a trigger for discussion between the ISC and Airservices on how best to deal with major upturns or downturns in volumes, actual CAPEX costs substantially exceeding forecast or regulatory requirements that have a significant cost implication.

In the event there is a major down turn in the market the worst thing for Airservices to do is to increase prices. This can cause a cost flow through to consumers of the services (ie air travellers) that well may act to stifle demand further. Increasing or decreasing prices is not the only option available to the ISC and Airservices in this case. Other options include delaying or bringing forward of CAPEX programs or changing non safety related service levels.

We note that any proposal for changes in price will require submission to the ACCC as well as consultation with all affected parties. With the time consultation takes, it may be best to find a suitable association that could act on behalf of general aviation and regional airlines as part of the process.

Virgin Blue accepted that the trigger mechanism only on the basis that the level of risk assumed in the asset beta parameter was reduced accordingly. The triggers as noted in the ACCC response were intended to be global and not for a specific location.

Generally we believe that the Airservices pricing proposal has the risks being borne by the organisations best able to manage those risks.

2.3 Building Block Methodology

2.3.1 Operational Expenses

The ACCC report notes that operational expenses make up over 80% of the overall allowable revenue within the building block model. In our first submission we commented that we were unable to identify whether all operational expenses were efficient.

One area of inefficiency was the labour costs and more specifically the cost of superannuation. We understand that currently Airservices has a costly defined benefit superannuation fund which is a legacy from the government ownership days and that all new staff are listed under an accumulation superannuation fund.

Fundamentally it is not an issue for Virgin Blue as to how Airservices manage their superannuation. What does concern us is that we are paying for excessive superannuation costs. We believe that any superannuation cost above that of an efficient organisation should be a government cost and therefore not be recovered using the building block model. If there was a competitive market for the services offered by Airservices these costs would not be able to be passed on by Airservices to their customers without being at a competitive disadvantage.

In relation to maintenance costs we note that Airservices reduced these due to the large CAPEX program which provides for the replacement or upgrading of older outdated sites/equipment, therefore increasing efficiencies. Virgin Blue is happy with the approach taken by Airservices to reflect this reduction in the model.

Other than labour cost and growth rates of labour which appear to be reasonable, we were unable to ascertain if other operating expenses in the model were efficient.

We note the ACCC point regarding the absence of an incentive mechanism. Although there is no explicit CPI-X price cap, history has told us that over the last 5 years Airservices' costs have decreased substantially. This has occurred mainly due to new technologies available. The ISC went through the CAPEX program and ensured that where it believed CAPEX could create efficiencies, this was reflected in the forward costs. Virgin Blue supports the ACCC view that CPI-X price cap be used in future long term pricing proposals.

2.3.2 Asset Base

Virgin Blue disagrees with the ODRC methodology for asset valuation. With regard to this submission Virgin Blue has an issue with the broad approach to asset valuation that Airservices used in its model.

One important issue is that now the assets have been valued, they will not be re-valued again for pricing purposes. The prices that have been agreed are to be the base going forward and depreciated accordingly. New assets are to be recorded at their purchase cost and depreciated from that base.

While this approach has been taken in this model due to the tight time frames, Virgin Blue would want this reviewed in any future long term pricing proposals

2.3.3 Capital Expenditure

Virgin Blue agreed to the CAPEX program originally proposed. This program created efficiencies due to a large component of CAPEX that replaced or upgraded current facilities or equipment that were quite outdated. These efficiencies provided benefits to both Airservices and the airlines.

A number of projects were taken out of the original CAPEX program due to the ISC deeming them unnecessary or suggesting a safer, more cost efficient alternative. However, without consulting with the ISC, Airservices made last minute changes to the program including providing for surface radars in Brisbane and Melbourne. These are highly expensive to buy and very costly to maintain due to the number of moving parts. ISC believed a better option would be for ADS-B stations to be adopted which are more cost effective and have no moving parts to maintain. Virgin Blue supports the ISC's recommendation.

2.3.4 Rate of return (WACC)

We note the comments from the ACCC on the issues surrounding asset beta, debt margin and the phasing in of the WACC. The phasing in proposal for the WACC was agreed by the ISC in an attempt to reduce some of the burden on the airlines due to the lengthy transition to location specific prices. The overall effect of the phasing in proposal was to reduce allowable revenue by $40.7m over the 5 year agreement.

The asset beta was an area of contention between the airlines and Airservices. Independent advice was sought by Airservices and this advice provided a range between 0.55 and 0.65. Generally, with most of the parameters, the mid point of the range was taken. This approach was also adopted for the WACC. However, we agree with the ACCC point of view that the lower end of the range be used due to the trigger mechanisms (ie 0.55 asset beta).

Regarding the ACCC issues over debt margin, we take note of the ACCC points regarding this parameter. With the credit rating of a government owned corporation the debt margin should be quite low. The ACCC suggested debt margin of 0.55 would make the risk free rate 5.41% and these are levels that Virgin Blue is willing to accept.

Virgin Blue strongly supports the ACCC suggested parameters as this would equate to an overall nominal vanilla WACC of 8.95%. This is a level that we believe is reasonable for Airservices. The ACCC has noted in their Preliminary View that this reduction in WACC would have the effect of decreasing allowable revenue by $22.2m.

In order for the airlines to be in the same position as that proposed by the phasing in proposal, allowable revenue will need to reduce by a further $18.5M. Virgin Blue recommends this occur by adopting a CPI – X approach to overall costs.

2.4 Activity Levels

Virgin Blue has agreed with the activity levels that Airservices has proposed as these have been obtained from an independent source, IATA.

General aviation and regional airlines have noted that demand may decrease by virtue of a price increase. We do believe overall that the IATA forecasts are reasonable and a best estimate of what will happen across the entire network and to try to come to a figure for all ports be they mainline, regional or general aviation would make the task too time restrictive, costly and possibly wouldn't add further to the information currently at hand. For these reasons we would support the current activity levels provided by Airservices.

2.5 Pricing Structure

2.5.1 Annualised price changes

The overall net effect of growth in allowable revenue appears reasonable. (This equates to a 5.8% net increase over 5 years).

2.5.2 Airservices Approach to allocation of Distributed costs

Although the level of distributed costs has been agreed by airlines the method of allocation has not been agreed. Virgin Blue believes the best method of allocation for distribution costs is by staff numbers.

To apportion these costs by any other method than the number of staff in a particular location would be inefficient. Airservices proposed to allocate distributed costs by way of a MTOW methodology. Virgin Blue disagrees with this proposal as the weight of an aircraft is not the main driver for this type of cost. To allocate distributed cost using a method that does not look at what drives the cost but looks at the user's ability to pay is inefficient. This is a method of attempting to move to network pricing.

To allocate costs based on "ability to pay" disadvantages low cost carriers over full serviced airlines. Virgin Blue and other low cost carriers have a more price sensitive customer base. While

Virgin Blue tries to control all costs and where possible, absorb any increases, there are times when we have no choice but to increase fares. As Virgin Blue attracts more price sensitive travellers, this has a real effect on demand.

2.5.3 Application of the basin concept in setting prices for Terminal Navigation Services

Virgin Blue disputes the use of the basin concept for allocation of costs for Terminal Navigation services. Where mainline airports utilise the Terminal Navigation Services at regional or general aviation airports, we would agree it is reasonable that this cost is apportioned between the airports. This is consistent with our support for a user pays system. However, it appears that the approach taken to by Airservices is very broad brush. There is no transparency of allocations and appears another attempt to move to network pricing.

2.5.4 Timing of Price Increases

Virgin Blue would prefer the cross subsidisation of services and locations to cease immediately. We have only agreed to accept this cross subsidisation in conjunction with Airservices' proposal detailed in Section 2.3.4.

2.5.5 Pricing across services and user groups

<u>Cross Subsidies</u>

As stated in the Preliminary View, En route subsidises Terminal Navigation and ARFF services to the amount of $22M per annum. RPT operators are seeking to cease this cross subsidisation of services and Virgin Blue would like to see this occur far more quickly than within the current price submission.

Historically there has been a large amount of cross subsidisation between locations by virtue of price capping at 10 regional locations for Terminal Navigation charges as well as more profitable locations supporting unprofitable locations. We see that Airservices is attempting fix this issue with a gradual move to cease the cross subsidisations between locations over the term of this agreement. We note this process could take up to 7 years at the rate proposed for relaxation of the price cap on the 10 regional locations. However, Virgin Blue once again would like to see this occur far more quickly than within the current price submission.

We reiterate that Virgin Blue is an advocate of location specific pricing. As the ACCC quite rightly noted it aligns prices with the costs for those services and sends correct efficiency signals for that location to the market.

<u>Basis of Airservices Charges</u>

Virgin Blue strongly supports continuing to charge for En route, Terminal Navigation and ARFF services on a weight basis. This is fundamental to Virgin Blue supporting the Airservices' proposal.

Although the number of passengers through an airport determines whether there is an ARFF operation, it is the size or category of the planes that fly to that port that determines the number of staff and vehicles required (as determined by the ICAO standards). This supports the point that the major cost driver for an ARFF service is the size of the aircraft that flies to the port and not the number of passengers. The best determinant for size of an aircraft is the MTOW of that aircraft. Once the ICAO requirement for reaching 350,000 passengers in any financial year is reached, the ARFF service provided will be the same regardless of whether there are 10 or 120 passengers on board.

2.6 Impact on Users

The net increase in allowable revenue for the five year agreement is 5.8% which Virgin Blue broadly supports. However, it is the allocation of this allowable revenue in determining the pricing which causes us concern. First, we note that the increase to Virgin Blue over the five year period is in excess of 13%, more than double that of the overall increase in allowable revenue. This is primarily due to the application of the basin concept and allocation of distributed costs.

Secondly, the effect on Virgin Blue would be exacerbated by a move from the current MTOW charging regime to a per passenger charge for ARFF Services. A per passenger charge penalises Virgin Blue as a low cost carrier for being efficient and maximising passenger loads to a point that is much greater than a full service airline.

3. Conclusion

Virgin Blue fundamentally disagrees with any change in the current charging methodology from MTOW to a per passenger rate.

Our other main concerns are:

- the basin concept for Terminal Navigation charges;
- the allocation of distributed costs; and
- the lack of ability to determine efficiencies in all operating expenses.

If these issues can be addressed, Virgin Blue would support the Airservices' proposal. In particular, it would be our preference that the ACCC suggested WACC be adopted together with the CPI – X proposal.