Australian
Competition &
Consumer
Commission

Airservices Australia price notification

Final decision

September 2011

Contents

Abbreviations and explanations

ACCC	Australian Competition and Consumer Commission
AER	Australia Energy Regulator
Airservices	Airservices Australia
ANSP	Air Navigation Service Providers
AOPA	Aircraft Owners and Pilots Association
ARFF	aviation rescue and fire fighting
ARTN	Australian Regional Tourism Network
AS Act	*Air Services Act 1995*
ATC	Air Traffic Control(ler)
BARA	Board of Airline Representatives of Australia Inc.
CAPM	Capital Asset Pricing Model
CASA	Civil Aviation Safety Authority
CCA	*Competition and Consumer Act 2010*
CPI	consumer price index
en route	en route navigation
FIR	Flight Information Region
GA	General Aviation
GAAP	General Aviation Aerodrome Procedures
KPIs	Key Performance Indicators
IATA	International Air Transport Association
ICAO	International Civil Aviation Organisation
LTPA	long-term pricing agreement
MRP	market risk premium
MTOW	maximum take-off weight
PCC	Pricing Consultative Committee
PS Act	*Prices Surveillance Act 1983*
Qantas Group	Qantas, Jetstar and Qantas Link
RAAA	Regional Aviation Association of Australia
TAS	technology and asset services
TN	terminal navigation
vanilla WACC	The weighted average of the post-tax return on equity and the pre-tax cost of debt
VAA	Virgin Australia Group of Airlines
WACC	weighted average cost of capital

The ACCC's decision

The Australian Competition and Consumer Commission's (ACCC's) decision is to **object** to Airservices Australia's (Airservices') proposed price increases for terminal navigation and aviation rescue and fire-fighting services. Charges for en route navigation services were proposed to decrease. The changes were proposed to take effect from 1 October 2011.

The ACCC considers that the rate of return on capital (WACC) proposed by Airservices is too high. This means that Airservices would over-recover the revenue required to cover efficient costs based on its proposed prices. The ACCC is satisfied, however, that Airservices has taken steps to address concerns raised in the ACCC's preliminary view that Airservices needs to improve its consultation with stakeholders on capital expenditure and improve its drivers of efficiency.

ACCC's Final Decision relative to its Preliminary View

Aspect of price notification	Status	Submission reference
Efficiency of the cost base		
Long-term pricing agreement	▪ No change	
Risk-sharing arrangements	▪ No change	Gold Coast Airport (pp.1-2), Qantas Group (p. 3), Virgin Australia (pp. 3-4), IATA (p. 2)
Performance measurement and monitoring	▪ KPIs to be introduced to the Services Charter (see internal drivers of efficiency)	See internal drivers of efficiency
Internal drivers of efficiency	▪ Airservices' proposed initiatives accepted. New measures to be incorporated in Services Charter. ▪ Efficiency targets and system of accountability for performance to be developed within 3 years	Airservices (pp. 11-13), Gold Coast Airport (p. 2), Qantas Group (p. 3), Virgin Australia (p. 4)
Consultation with users	▪ Airservices' proposed processes and initiatives accepted. ▪ Airservices to agree and commit to timing of information provision to stakeholders.	Airservices (pp. 10-11), BARA (p. 4), Gold Coast Airport (pp. 2-3), Qantas Group (pp. 2-3), Virgin Australia (p. 3)
International benchmarking	▪ Separation of oceanic and continental costs to be considered to improve international benchmarking comparisons to assist setting of efficiency targets.	IATA (pp. 3-4)
Activity forecasts	▪ No change	Adelaide Airport (p. 2), Gold Coast Airport (p. 1)
Building Block model		
Operating costs	▪ No change	Air New Zealand (p. 1), Cathay Pacific (p. 1), RAAA (p. 1), Qantas Group (pp. 2-3), Virgin Australia

		(p. 4), Gold Coast Airport (p. 2)
Opening asset base	▪ No change	IATA (p. 3)
Capital expenditure	▪ No change	See consultation with users
Return of capital (depreciation)	▪ No change	IATA (p. 3)
Rate of return on capital (WACC)	▪ Airservices proposed a revised rate of return (WACC) of 9.12 per cent, rather than 9.95 per cent. ▪ The ACCC does not accept Airservices' revised proposal. The ACCC considers that a WACC of 9.12 per cent is too high. This means that Airservices would over-recover its required revenue based on its proposed prices.	Airservices (pp. 14-29), Air New Zealand (p. 1), BARA (pp. 2-3), Emirates (p. 1), Gold Coast Airport (p. 2), IATA (p. 2), Qantas Group (p. 4), Virgin Australia (p. 5)
Prices and structure of prices		
Allocation of costs	▪ No change	IATA
Pricing across services and locations	▪ No change	Adelaide Airport (pp. 1-3), Air New Zealand (p. 1), BARA (pp. 1-3), IATA (pp. 2-3), RAAA (p. 1), Rex (pp. 1-2)
Basis of charges	▪ No change	Cathay Pacific (pp. 1-2), Emirates (p. 1), Virgin Australia (p. 5), Gold Coast Airport (p. 2)
Timing of recovery of capital costs	▪ Airservices to make explicit provision for stakeholders to ascertain Airservices' adherence to ICAO principles for prefunding.	Qantas Group (p. 4)

Part A: Introduction

This paper sets out the Australian Competition and Consumer Commission's (ACCC's) decision on a formal price notification submitted by Airservices Australia (Airservices) covering all of its regulated services: terminal navigation (TN), en route navigation (en route), and aviation rescue and fire-fighting (ARFF) services.

The price notification includes prices for a five-year period, 2011-12 to 2015-16, and includes increases to its charges for TN and ARFF services, while charges for en route services are reduced. Some changes to pricing methodology and structure are also proposed. The changes are proposed to take effect from 1 October 2011. The details of Airservices' proposed prices are set out in **appendix A**.

The ACCC's consideration of the Airservices' formal price notification follows the ACCC's consultation on, and assessment of, a draft price notification that was provided to the ACCC in March 2011. This was done in accordance with the ACCC's informal pre-lodgement process for assessing price notifications under Part VIIA of the *Competition and Consumer Act 2010* (CCA).

This decision document should be read in conjunction with the ACCC's preliminary view, which is available on the ACCC's website at: www.accc.gov.au/aviation.[1]

The remainder of this Part provides a summary of Airservices' formal price notification (**section 1**) and the ACCC's role in assessing Airservices' price notifications (**section 2**). **Section 3** outlines the ACCC's process of assessment for Airservices' formal price notification, while **section 4** provides a summary of the ACCC's preliminary view. **Part B** outlines the ACCC's final view on the components of Airservices' formal price notification.

1 Airservices Australia's formal price notification

Airservices has revised its rate of return on capital (WACC) in its formal price notification to 9.12 per cent, which has led to a $52 million reduction in its required revenue compared to the amount proposed in its draft price notification. Airservices states that, as a consequence of this reduction in its required revenue, the following changes have been made to its prices compared to those proposed in its draft price notification:

- TN—prices were amended where the over-recovery was significant. Affected locations where prices were adjusted include Adelaide, Cairns, Canberra, Karratha, Maroochydore (Sunshine Coast), Perth and Rockhampton.[2]

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[1] www.accc.gov.au/aviation > Airservices Australia > Price notifications > Long-term price notification 2011 > ACCC's preliminary view and submissions received.

[2] On page 9 of its formal price notification, Airservices did not include Perth in the list of affected locations where TN prices were adjusted. However, the ACCC notes that the price for Perth has also been revised (downwards) when compared to Airservices' draft price notification.

- ARFF—revisions were made to ARFF Category 6 prices.[3] No further revisions were made to ARFF prices with the reduction to the rate of return no providing any significant areas of service price over-recovery. This also recognises the need to continue to transition ARFF services prices toward full cost recovery.

- En route—the remaining reduction to bring prices in line with allowable revenues has been carried through to en route service prices to help further minimise the over-recovery in that service.[4]

The details of Airservices' proposed prices and formulas for calculating charges are set out in its formal price notification and have been reproduced in **appendix A** of this decision document.

A summary of Airservices' proposed changes to its existing charging arrangements is also set out in its formal price notification, and has been reproduced in table 1.1 below. Airservices noted that, apart from a revision to its prices as outlined above, the changes to its existing charging arrangements are the same as those embodied in its draft price notification.

Table 1.1: Summary of Airservices' proposed changes to charging arrangements

Service	Current charging arrangements	Proposed charging arrangements
En route	▪ Levied on IFR flights only ▪ Based on aircraft weight (MTOW) and distance flown	▪ As per current charging arrangements <u>Plus:</u> ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t
TN	▪ Levied on IFR and VFR full stop landings and practice instrument approaches ▪ Based on aircraft weight (MTOW) ▪ Capital city basin pricing ▪ Price capping at GA and regional locations	▪ As per current charging arrangements <u>Plus:</u> ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t ▪ Price capping across all locations

3 On page 9 of its formal price notification, Airservices advised that no revisions were made to ARFF prices. However, the ACCC notes that the price for ARFF Category 6 aircraft has been revised (downwards) when compared to Airservices' draft price notification.

4 Airservices Australia, *Formal price notification*, 22 August 2011, p. 9.

Service	Current charging arrangements	Proposed charging arrangements
ARFF	▪ Applies to aircraft with MTOW > 15.1t or "target" aircraft with MTOW between 5.7t and 15.1t ▪ Levied on full stop landings and practice instrument approaches ▪ Based on aircraft weight (MTOW) and aircraft ARFF category	▪ As per current charging arrangements Plus: ▪ Weight capping for large aircraft ▪ Average MTOW of aircraft if > 15.1t ▪ Call-out charge for non-aviation false alarms
General Aviation	▪ Charges under standard contract or light aircraft option (LAO)	▪ Cessation of LAO ▪ Simplification of charging ▪ Free access for low volume general aviation users ▪ Fixed price option available
Risk-sharing	▪ Flight activity volumes +/- 5 per cent of agreed revenue levels ▪ Regulation changes leading to changes in operating cost or investment ▪ Capital expenditure 50 per cent of agreed single year expenditure, or 25 per cent agreed expenditure on a cumulative basis	▪ As per current charging arrangements Except: ▪ Capital expenditure 20 per cent of agreed single year expenditure, or 10 per cent on a cumulative basis

Source: Airservices Australia, *Formal price notification*, 22 August 2011, p. 6.

In its formal price notification, Airservices has also provided a detailed response to each of the elements of concerns raised by the ACCC in its preliminary view, including capital expenditure consultation, drivers of efficiency and rate of return on capital. Airservices' response on these issues is discussed in more detail in **Part B** of this document.

Information about Airservices, including its establishment as a statutory authority, ministerial responsibility and functions is contained in **appendix C** of this document.

2 The ACCC's role in the regulation of Airservices Australia

The provision of TN, en route and ARFF services by Airservices is declared under section 95X of the CCA. The relevant declaration, Declaration no. 66, is available on the ACCC website at: www.accc.gov.au/aviation.[5]

[5] www.accc.gov.au/aviation > Airservices Australia > Declaration No. 66.

Under section 95Z of the CCA, Airservices is required to notify the ACCC of proposed price increases in these declared services. Under subsections 95ZB(6) and 95ZB(1) of the CCA, the ACCC has 21 days to respond to a formal price notification.

In exercising its powers and performing its functions in relation to price notifications, the ACCC is required to have particular regard to the matters set out in subsection 95G(7) of the CCA. The ACCC applies this legal framework according to the concepts and procedures outlined in its *Statement of regulatory approach to assessing price notifications* (June 2009), which is available on the ACCC's website at: www.accc.gov.au.[6]

More information on the regulatory and legal framework that applies to the ACCC's assessment of Airservices' price notifications is contained in **appendix D**.

3 Process of assessment

As noted above, the price notification process provided for in subsections 95ZB(6) and 95ZB(1) of the CCA proscribes a period of 21 days for the ACCC to form a view on the proposed price increases. This period of time is not sufficient for the ACCC to give full consideration to the complex issues presented in the assessment of a price notification.

The ACCC has therefore established an informal pre-lodgement process, outlined in its *Statement of regulatory approach to assessing price notifications* (June 2009), which facilitates the ACCC's consideration of complex issues often raised in price notifications.[7] This process involves the regulated firm providing a draft price notification for the ACCC's consideration prior to submitting a formal price notification under section 95Z of the CCA.

The following summarises the ACCC's assessment of Airservices' proposal:

- On 7 March 2011, Airservices submitted a draft price notification to the ACCC in accordance with the ACCC's informal pre-lodgement process for assessing price notifications under Part VIIA of the CCA.

- On 7 April 2011, the ACCC released an issues paper seeking submissions from interested parties on the proposed price increases and changes to pricing methodology and structure embodied within Airservices' draft price notification. The ACCC received a total of 14 submissions from airports, airlines, airline associations and other stakeholders.

- On 7 July 2011, the ACCC released its preliminary view on Airservices' draft price notification and called for submissions from interested parties. The ACCC indicated

[6] www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

[7] The ACCC's *Statement of regulatory approach to assessing price notifications* is available on the ACCC's website at www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

in its preliminary view that it would object to Airservices' proposed price increases (see section 4 below). The ACCC received a total of 12 submissions from airports, airlines, airline associations and other stakeholders.

- On 22 August 2011, Airservices submitted a formal price notification to the ACCC. More detail on Airservices' proposal is provided in section 1 above. The prices set out in the price notification are proposed to take effect from 1 October 2011.

- On 8 September 2011, the ACCC released this final decision on Airservices' formal price notification.

4 The ACCC's preliminary view

4.1 Issues considered by the ACCC in its preliminary view

The ACCC approaches its assessment of price notifications drawing on the principles of economic efficiency. This includes assessing the incentives of the firm to operate efficiently. The ACCC uses a cost-based building-block methodology to estimate whether forecast prices reflect efficient costs.

As outlined in the preliminary view, the price increases in Airservices' price notification are primarily driven by cost increases—both capital and operating. The ACCC considered it fundamental to its assessment of Airservices' proposal to understand the incentives that Airservices faces to operate efficiently. As a government-owned business, Airservices has both financial and non-financial incentives. Understanding these incentives allows judgment to be made about the likely efficiency with which Airservices operates and invests. Section 5 of the preliminary view discussed the efficiency of Airservices' cost base in the context of incentives and risk.

4.2 The ACCC's preliminary view

In its preliminary view, the ACCC indicated that it would object to Airservices' proposed price increases for TN and ARFF services. In particular, that:

> In undertaking its assessment of Airservices' draft price notification, the ACCC has identified a number of key issues that it considers that Airservices needs to address prior to submitting its formal price notification.
>
> ***Airservices needs to improve its level of consultation with stakeholders to ensure prudency and efficiency of capital expenditure***
>
> The ACCC is concerned that Airservices has not undertaken adequate consultation with stakeholders to ensure that its capital expenditure program is being undertaken prudently and efficiently. Indeed, a number of stakeholders have expressed concerns relating to the level of information provided by Airservices, the effectiveness of the consultation, and that stakeholders' views have not been taken into account or have not been addressed. For example, stakeholders have raised concerns in relation to the ATM Future System project included in Airservices' proposed capital expenditure.
>
> The ACCC considers that there is scope for Airservices to improve its consultation processes to allow stakeholders to provide more informed input on the benefits and costs of specific projects.

> Stakeholders are in a strong position to assess the value of capital investment proposals by, for example, providing feedback on activity forecasts and service-quality preferences.
>
> ***Airservices needs to improve its drivers of efficiency***
>
> The ACCC considers that, although Airservices has made some progress in incorporating efficiency targets and benchmarks, there is still scope for it to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets.
>
> ***Airservices needs to review its methodology for estimating its rate of return on capital***
>
> The ACCC does not accept Airservices' proposed rate of return on capital as appropriate for this assessment on the basis that it does not accept the methodology applied by Airservices in estimating the nominal risk-free rate and cost of debt margin. Any adjustment to the rate of return on capital needs to be reflected by an associated adjustment to the required revenue and prices for users.

The preliminary view noted that, if Airservices could address these matters prior to submitting its formal price notification, then the ACCC would be minded to not object.

The ACCC sought general comments from interested parties on its preliminary view.

Part B: Response to the ACCC's preliminary view

Responses are summarised in this Part under the same headings that were used in the preliminary view, together with the ACCC's final view on each of the issues.

5 Efficiency of the cost base: incentives and risks

This section discusses the following issues:

- long-term pricing agreement (section 5.1)
- risk-sharing arrangements (section 5.2)
- performance measurement and monitoring (section 5.3)
- internal incentives for efficiency (section 5.4)
- formal consultation mechanisms (section 5.5)
- international benchmarking (section 5.6).

Section 5.7 provides a summary of the ACCC's assessment of these aspects.

5.1 Long-term pricing agreement

5.1.1 ACCC's preliminary view on long-term pricing agreement

The ACCC welcomed Airservices' long-term approach to its pricing and noted stakeholders' general support for the long-term pricing agreement (LTPA). Whilst acknowledging concerns raised in submissions to the ACCC's issues paper that the LTPA could provide Airservices with an incentive to overestimate costs, the ACCC considered that, on balance, there are significant benefits in establishing a LTPA.

In its preliminary view, the ACCC noted that, where Airservices first submits a price notification that includes a LTPA, the ACCC conducts a detailed assessment of the substance of the proposed prices over the full period covered by the LTPA. The ACCC will then make a decision on the proposed prices covering the first year of the period. Airservices will be required to submit to the ACCC locality notices for each of the subsequent years covered by the LTPA. For those subsequent years, the ACCC may consider it appropriate to conduct a short-form assessment process.[8]

[8] The short-form assessment process provides scope for the ACCC to adopt an expedited assessment. A more detailed discussion of the short-form assessment process is provided in the ACCC's *Statement of regulatory approach to assessing price notifications*, which is available on the ACCC's website at www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

5.1.2 ACCC's final view on long-term pricing agreement

Submissions did not provide comment on the use of a LTPA. The ACCC therefore confirms its preliminary view on the LTPA.

5.2 Risk-sharing arrangements

Tables 5.1 and 5.2 below summarise the proposed risk-sharing arrangements and trigger points for shortfalls in capital expenditure that were outlined in Airservices' draft price notification.

Table 5.1: Airservices' proposed trigger mechanisms for a review of pricing under its risk-sharing arrangements

Current trigger mechanism	Proposed trigger mechanism
Where flight activity volumes result in surpluses or deficits that exceed 5 per cent of the proposed revenues.	No change proposed.
Where shortfalls in capital expenditure are either less than **50 per cent** of agreed expenditure in a single year, or less than **25 per cent** of agreed capital expenditure on a cumulative basis.	Where shortfalls in capital expenditure are either less than **20 per cent** of agreed expenditure in a single year, or less than **10 per cent** of agreed capital expenditure on a cumulative basis.
Where regulatory changes lead to operating cost changes or require new investment.	No change proposed.
	The introduction of new services to have a three month grace period from the services' commencement date before charging begins. Prices for new services will then be reviewed after 12 months to determine whether there has been a significant change in flight activity volumes.

Table 5.2: Risk-sharing trigger points for shortfalls in capital expenditure

Capital expenditure	2011-12	2012-13	2013-14	2014-15	2015-16
Annual capital expenditure proposed	206	187	194	186	185
20% annual risk threshold	185	168	174	168	166
Cumulative capital expenditure proposed	206	392	586	773	958
10% cumulative risk threshold	n/a	353	528	695	862

Source: Airservices Australia, *Draft price notification*, March 2011, p. 50.

5.2.1 ACCC's preliminary view on risk-sharing arrangements

The ACCC welcomed Airservices' continuing commitment to its risk-sharing arrangements. In particular, the ACCC noted that, in submissions to its issues paper on

Airservices' draft price notification, stakeholders generally expressed support for the continuation of these arrangements. However, the ACCC made the following specific comments in relation to each of the risk-sharing arrangements:

Activity and regulatory changes

The ACCC considered that, because there has been no change to the arrangements, Airservices has not taken on additional level of risk in its draft price notification in relation to its activity and regulatory changes risk-sharing arrangements. This is relevant to the return on capital discussion in section 7.5 of this document. The ACCC also noted that there may be merit in Airservices and particular airports entering into individual risk-sharing arrangements. This is relevant to the activity forecasts discussed in section 6.

Trigger mechanism for shortfalls in capital expenditure

The ACCC considered that the trigger mechanism for shortfalls in capital expenditure does not, of itself, provide an incentive for Airservices' to undertake prudent investment. Further, the ACCC considered that the arrangements do not of themselves provide Airservices with an incentive to manage the risk of cost over-runs on individual projects. This is relevant to the incentives discussion throughout the rest of section 5. The ACCC also noted that the proposed amendments were unlikely to result in a significant change to level of risk borne by Airservices. This is relevant to the rate of return on capital discussion in section 7.5.

In its preliminary view, the ACCC stated that, in order to provide appropriate incentives, there needs to be sufficient transparency and accountability by Airservices to its stakeholders for delivering on individual projects. As discussed in sections 5.3 and 5.5, this includes providing stakeholders with regular delivery status updates on its capital expenditure program on project-by-project basis for projects over $10 million. This should also include a comparison of projected costs versus actual costs, which the ACCC notes is also relevant to Airservices' reconciliation of its opening asset base for future price notifications (see section 7.2).

Grace period for new services and a twelve month review

The ACCC considered that this arrangement had similar effect to the existing activity risk-sharing trigger. Therefore, the ACCC did not consider that Airservices had taken on any additional level of risk. This is relevant to the rate of return on capital discussion in section 7.4.

5.2.2 Views of interested parties on risk-sharing arrangements

Gold Coast Airport submitted that where there is an over-recovery, a formula needs to be prepared so that airports that have strong growth are afforded a price decrease much earlier in the five year plan. Further, Gold Coast Airport stated:

> A pricing trigger needs to be agreed and simple. When the volumes reach a point at specific locations then a price reduction needs to be calculated. Conversely a review of services also needs to be conducted when the traffic numbers are not as strong.

> Gold Coast Airport also supports the risk-sharing arrangements in principle, however we would like to see KPIs or reports on capex particularly those that are related to our location. For example, the control tower was due to be upgraded as we understand it during the last pricing round. The tower has still not had any upgrade works commenced and is in need of attention.[9]

Qantas submitted that Airservices should tighten the trigger points for capital expenditure risk-sharing. More specifically, Qantas submitted that:

> 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.[10]

VAA stated that:

> Airservices acceptance in undertaking to present summary business cases for all projects greater than $10million to the PCC is a positive step towards Airservices improving its consultation. VAA also echo the view of the ACCC in that industry needs to be totally satisfied that Airservices has formal mechanisms in place for consultation with users that provide ongoing transparency to, and accountability for, their performance.
>
> If past experience tells us anything Airservices' inability to deliver projects on time and on budget has been questionable. To some extent Airservices' failure to meet industry expectations has reflected a staffing shortfall although the poor outcome has been more likely attributable to the lack of good quality project management.[11]

IATA supported the ACCC's preliminary view noting that there is a need to implement an adequate monitoring mechanism on a project-by-project level in order to ensure prudent and efficient delivery of the capital program. IATA stated that 'this is necessary as the current capex risk-sharing mechanism could provide a perverse incentive to invest in unnecessary projects in order to reach minimum thresholds'.[12]

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9 Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, pp. 1-2.

10 Qantas, *Submission in response to the ACCC's preliminary view*, 29 July 2011, p. 3.

11 VAA, *Submission in response to the ACCC's preliminary view*, 1 August 2011, pp. 3-4.

12 IATA, *Submission in response to the ACCC's preliminary view*, 27 July 2011, p. 2.

5.2.3 Airservices' response on risk-sharing arrangements

Airservices did not provide any comments on the ACCC's preliminary view on risk-sharing arrangements.

5.2.4 ACCC's final view on risk-sharing arrangements

The ACCC reaffirms its preliminary view that the risk-sharing arrangements do not of themselves provide Airservices with an incentive to undertake prudent and efficient investment. Further, that Airservices is unlikely to have taken on any additional level of risk as a result of the proposed changes. Nevertheless, the ACCC also considers that there is some benefit to users of having the risk-sharing arrangements in place, and stakeholders remain generally supportive of the arrangements. As such, the ACCC remains of the view that the risk-sharing arrangements are a positive inclusion in Airservices' LTPA.

The ACCC notes the comments made by Gold Coast Airport relating to the need for a formula to determine the amount to be returned to users where there has been an over-recovery as a result of actual activity levels deviating from forecast levels. The ACCC considers that Airservices should consult with its users to determine how best to return funds to users where there has been an over-recovery. The ACCC reiterates its view that there may be merit in particular airports entering into individual risk-sharing arrangements.

Also, the ACCC notes the comments made by Qantas, VAA, Gold Coast Airport and IATA on the need to ensure that Airservices has additional incentives to undertake prudent and efficient investment. As discussed in the remainder of section 5, the ACCC is satisfied that Airservices' commitment to improving its formal efficiency targets will provide incentives to operate efficiently. Further, the ACCC is satisfied that Airservices' commitment to improving its consultation for capital expenditure as well as its level of transparency and accountability for delivering on agreed capital expenditure projects will provide incentives to undertake prudent investment.

In relation to Qantas' specific comments regarding the capital expenditure trigger points, the ACCC encourages Airservices to continue to review and consult with users on the appropriate levels for future LTPAs.

5.3 Performance measurement and monitoring

In its preliminary view the ACCC noted the development of Airservices' Services Charter as an initiative to improve the measurement and monitoring of its performance. The ACCC noted the Services Charter was still being developed and there was scope to strengthen its accountability function by incorporating a requirement for Airservices' to provide a response when any KPIs are not met.

Strengthening of the Charter is discussed in further detail in the context of Airservices' internal drivers of efficiency (section 5.4).

5.4 Internal drivers of efficiency

5.4.1 ACCC's preliminary view on internal drivers of efficiency

In its preliminary view, the ACCC considered that there was scope for Airservices to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets.

Specifically, the ACCC stated that this could be achieved by Airservices committing to incorporating additional KPIs relating to productivity and efficiency into the Services Charter, in consultation with its users. The ACCC stated that further, that the KPIs should be accompanied by Airservices' response according to performance outcomes.

5.4.2 Views of interested parties on internal drivers of efficiency

Stakeholders welcomed the ACCC's views regarding the need for Airservices to adopt efficiency targets and benchmarks.

Qantas sought a commitment from Airservices, and a timeframe of not greater than three years, to negotiate and determine financial or pricing consequences for not achieving the agreed KPIs.[13]

VAA stated that Airservices' decisions to introduce more efficient processes, or to invest in efficiency-increasing technologies over time, should be determined in accordance with industry-agreed consultative processes. VAA stated that this had not always occurred.[14]

Gold Coast Airport stated that it would like an explanation for why there is a marked increase or discrepancy in price for services in locations providing similar levels of service. Gold Coast Airport stated it would like comparative information for 'like towers with like towers, and like fire station categories with like fire station categories' in order to ascertain why price differences exist that cannot be attributed to traffic volumes.

Gold Coast Airport also stated that TN and ARFF services were oversupplied at that location. It stated that Category 8 ARFF services were only required for the first few hours of the day yet are provided for the full 17 hours per day.[15]

5.4.3 Airservices' response on internal drivers of efficiency

In its response to the ACCC's preliminary view, Airservices proposed to develop, in conjunction with the PCC, a set of measures of unit cost efficiency. Airservices provided a set of proposed indicators for measurement of past movements in cost

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13 Qantas Group, *Submission in response to the ACCC's preliminary view*, 29 July 2011, p. 3.

14 Virgin Australia Group of Airlines, *Submission in response to the ACCC's preliminary view*, 1 August 2011, pp. 3-5.

15 Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

efficiency, and for ongoing performance reporting. This had been circulated to the PCC for feedback. Airservices committed to including these in the Service Charter, which was being reviewed with industry. Airservices committed to commence reporting in the current financial year (2011-12).

Airservices considered that it was too early to be prescriptive about the information to be gathered and targets to be set, and that this was a matter to be discussed as part of the PCC process. Airservices highlighted the risks of determining cost efficiency measures and targets too quickly, and the potential for unintended consequences resulting from the use of inappropriate measures and targets.

With regard to longer-term performance incentives Airservices considered that it already had strong incentives to minimise costs over the five-year LTPA, as cost reduction or overruns relative to forecasts are borne by Airservices. Nonetheless, Airservices stated its intention to explore with industry the possibilities for a more sophisticated form of cost benchmarking in the longer term, including how specific financial rewards and penalties for performance against a suite of KPIs might be implemented. Airservices further stated its intention to refine efficiency targets based on analysis of the historical trends, forecast outcomes and international benchmarking over the next 12 months.

5.4.4 ACCC's final view on internal drivers of efficiency

The ACCC notes that Airservices has taken steps to establish a system of internal benchmarking, using a set of unit cost efficiency measures to be developed in conjunction with the PCC. The ACCC further notes Airservices' commitment to commence reporting on these within the current financial year.

The ACCC notes that Airservices has not developed specific targets or a system of performance-based rewards and penalties. The ACCC considers that the reasons provided by Airservices for this—in particular the potential for adverse consequences of implementing inappropriate targets—are not unreasonable. The ACCC further notes that Airservices has committed to refining specific efficiency targets based on analysis of the historical trends, forecast outcomes and international benchmarking over the course of the next 12 months. The ACCC considers it reasonable to expect that Airservices will have developed and implemented efficiency targets and corresponding responses within three years from the commencement of the LTPA.

In addition, ACCC refers to its comments regarding international benchmarking (section 5.6), and urges Airservices to take any steps necessary to ensure that comparisons are appropriate, and the limitations of international comparisons are taken into account when assigning weight to those results.

5.5 Consultation with users to ensure prudency in capital expenditure

5.5.1 ACCC's preliminary view on consultation with users

In its preliminary view, the ACCC considered there was scope for Airservices to improve its consultation processes to allow stakeholders to provide more informed input on the benefits and costs of specific projects. Airservices advised the ACCC that it had undertaken to present summary business cases for all projects greater than $10 million to the PCC. The ACCC stated that it required evidence that this process had been established prior to Airservices submitting its formal price notification.

In addition, the ACCC considered that formal mechanisms were needed in order to provide ongoing transparency to, and accountability for, Airservices' delivery performance. The ACCC considered that this could be achieved by Airservices committing to provide the PCC with details on the outcomes of consultation, such as the reasons for its decisions, as well as its continued commitment to provide updates on the progress of delivery of individual projects, for projects greater than $10 million.

5.5.2 Views of interested parties on consultation with users

A number of stakeholders reiterated concerns regarding the need for improved consultation. BARA noted that Airservices had not adequately addressed its previous concerns, nor those expressed by the ACCC in its 2004-05 decision, during the course of the previous LTPA.[16] Qantas specified a number of elements that would need to be included in a formal consultation process.

Gold Coast Airport stated there was a lack of accountability regarding capital expenditure, noting an overdue upgrade and critical maintenance of its control tower, and lack of investment in navigational aids.[17]

Qantas Group reiterated its concerns regarding the inclusion of the ATM Future Systems Project in the proposed capital expenditure program given the lack of information available about the project.[18]

Overall, stakeholders welcomed the ACCC's preliminary view in relation to consultation on capital expenditure, which were largely based on concerns raised by stakeholders in the initial round of consultation.

5.5.3 Airservices' response on consultation with users

In its response to the ACCC's preliminary view, Airservices stated that it had discussed with the PCC, at its meeting of 27 May 2011, how improvements could be made to the consultation process, and identified and agreed on a number of core elements. Airservices stated that these would provide greater transparency and informed input to capital project decision making, as well as improved ongoing monitoring of program delivery performance.

16 BARA, *Submission in response to the ACCC's preliminary view*, 28 July 2011, pp. 1-3.

17 Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

18 Qantas Group, *Submission in response to the ACCC's preliminary view*, 29 July 2011, p. 4.

Airservices outlined five elements of the consultation process as follows:

> i) Program Baseline
>
> A more detailed program baseline will be provided to establish major delivery milestones to enable improved program performance monitoring. The baseline will detail planned project benefits, project costs and project milestones as they were incorporated into the Draft Price Notification. It will be the original record against which delivery will be measured and risk sharing triggers monitored.
>
> ii) Major Project Business Case Options
>
> Project business case information will be presented to the PCC for all projects greater than $10m. This information will be provided prior to Airservices Board endorsement to improve transparency over, and industry input to, the determination of a preferred option. At this time, the business case information will be more mature, with refined information on project objectives, scope, benefits, costs and schedules. The final format of this business case information was agreed at the PCC meeting on 16 August 2011 and formal reporting will commence from the PCC meeting scheduled for 16 November 2011.
>
> iii) Project Baseline
>
> Following the approval of the preferred option, a final project baseline will be provided to the PCC. This baseline will include a final scope, cost/benefit analysis and schedule that will form the basis against which project delivery performance will be measured. Formal reporting will commence at the PCC meeting scheduled for 16 November 2011.
>
> iv) Quarterly Reporting
>
> As part of the quarterly service charter performance reports to the broader industry, high level capital program performance will continue to be reported. These reports will provide indicators on program health against annual targets. More detailed information will be provided to the PCC including a financial analysis and delivery schedule management, as well as information on deviations from the LTPA program baseline. This reporting commenced at the PCC meeting on 27 May 2011, with enhanced reporting scheduled to commence at the PCC meeting on 16 November 2011 following agreement to the elements above.
>
> v) Benefits Realisation
>
> Airservices will report on the benefits realised from capital works projects. The benefits identified will be reported annually and measured against original project baseline benefits realisation plans. Measurement of the benefits will be monitored on an ongoing basis to provide a cumulative picture of the benefits yielded. [19]

5.5.4 ACCC's final view on consultation with users

The ACCC considers that Airservices' proposed capital expenditure consultation processes address the specific points made by the ACCC in its preliminary view, and summarised above.

The ACCC notes that the proposed processes provide more scope for industry input as project options are to be presented within a framework of expected project benefits and costs. The processes also include mechanisms with which to measure the project

[19] Airservices Australia, *Formal price notification*, 22 August 2011, p. 10.

delivery performance. Annual reporting will provide an additional layer of accountability over the longer term.

The ACCC is satisfied that the processes have been formulated in consultation with the PCC, and that steps have been taken to establish these consultation and reporting mechanisms.

In order to ensure stakeholders have timely access to information, Airservices should commit to a timeframe within which it will provide stakeholders with information. For example, Qantas has suggested that business cases and quarterly reports be provided at least ten days prior to the relevant meetings.

The ACCC reiterates its view regarding the inclusion of the ATM Future Systems Project. The ACCC considers that the removal of projects from the LTPA could compromise the benefits of a long term approach. That said, the ACCC notes that the extent to which Airservices' implements improved consultation processes with users will be relevant to whether the short form process will be appropriate for the assessment of its annual locality notices. In addition the ACCC expects that more information about this project will be provided to users as it becomes available.

5.6 International benchmarking

5.6.1 ACCC's preliminary view on international benchmarking

In its preliminary view, the ACCC considered that the results of international benchmarking can provide some insight into the comparative efficiency Airservices' operations. Acknowledging the limitations inherent in international benchmarking exercises, the ACCC's focus was on any large or obvious differences in Airservices' results compared to other ANSPs.

The ACCC stated that it was satisfied that the international benchmarking results, provided by Airservices (including some provided on a confidential basis) did not highlight any areas of particular concern.

5.6.2 Views of interested parties on international benchmarking

IATA considered that there was a need for further development of international benchmarking. IATA expressed concern that the comparisons provided by Airservices did not provide the necessary information to determine whether Airservices is more or less efficient than its peers. IATA further considered that only a clear separation of costs between continental and oceanic services would provide a relevant base point for comparisons.

IATA noted the importance of the development of more accurate external benchmarking tools in conjunction with stakeholders, in validating any cost efficiency targets that are set for Airservices (as discussed in section 5.4 above).

5.6.3 Airservices' response on international benchmarking

Airservices' did not provide any comments on the ACCC's preliminary view on international benchmarking.

5.6.4 ACCC's final view on international benchmarking

The ACCC notes that Airservices has participated in CANSO studies but has opted for the results not to be published in the CANSO benchmarking report. As part of the current price notification assessment process, Airservices provided the results of the CANSO study, which included Airservices data, to the ACCC on a confidential basis.

As noted above, the ACCC considers that international benchmarking and comparisons results can contribute to the mix of information required to make judgments about the efficiency of Airservices' operations. The ACCC accepts that external benchmarks would be helpful in validating the cost targets to be developed for Airservices. That said, the ACCC recognises the inherent limitations of international comparative data.

To the extent that a separation of costs of oceanic and continental en route services can enhance the scope for more accurate comparisons with other ANSPs, and assist in the development of more accurate cost targets, the ACCC encourages Airservices to develop the required data in conjunction with stakeholders. The ACCC notes that Airservices has undertaken to restructure en route charges along functional lines and that this transition may not occur in the period of the proposed LTPA.

More generally, the ACCC encourages Airservices to continue to submit data to CANSO and other reputable international benchmarking and comparison studies, such that its data can be analysed using the methodologies applied by those respective studies (as opposed to simply comparing own data with the published study results). The ACCC expects that the results of these studies will be made available to the ACCC for assessment in the price notification process.

5.7 Summary of risks and incentives for efficiency

The ACCC considers that Airservices has addressed the concerns raised in the preliminary view in relation to risks and incentives for efficiency.

In particular, the ACCC notes the steps Airservices has taken to develop cost efficiency measures in conjunction with stakeholders, and the commitment it has made to refining efficiency targets during the next 12 months.

The ACCC considers it reasonable to expect that Airservices will have developed and implemented efficiency targets and corresponding responses within three years from the commencement of the LTPA.

In addition, ACCC refers to its comments regarding international benchmarking (section 5.6), and urges Airservices to take any steps necessary to ensure that comparisons are appropriate, and the limitations of international comparisons are taken into account when assigning weight to those results.

The ACCC also notes the commitments and steps already taken by Airservices to improve processes for consultation with stakeholders. To ensure stakeholders have timely access to information, Airservices should commit to providing any relevant documentation to stakeholders at least 10 days prior to meetings.

The ACCC notes that Airservices' progress in these areas will be relevant to whether the short form process will be appropriate for the assessment of its annual locality notices.

6 Activity forecasts

6.1.1 ACCC's preliminary view on activity forecasts

The ACCC's preliminary view was that Airservices' general approach to developing activity forecasts in consultation with IATA is consistent with its 2004-05 LTPA and, therefore, was considered reasonable.

The ACCC acknowledged, however, that activity forecasts were likely to be more accurate at the aggregate level than at an individual airport level. The ACCC noted that the activity risk-sharing arrangements embodied in Airservices' proposal provide a trigger mechanism for review of pricing where actual activity levels differ significantly from forecast levels. Nevertheless, the ACCC encouraged Airservices to consider whether alternative risk-sharing arrangements would be appropriate for some individual airports.

6.1.2 Views of interested parties on activity forecasts

Gold Coast Airport noted that it had previously raised discrepancies between its activity forecasts and Airservices' activity forecasts. Gold Coast Airport submitted that:

> Benchmarking the forecast provided by Airservices and the forecasts we have prepared for our Board and our financiers remain at odds as we have previously pointed out.
>
> Airservices and each airport should fundamentally agree on the traffic volumes so that prices are a more accurate representation of the activity.[20]

Adelaide Airport submitted that the traffic forecasts for its airport appear conservative. In particular:

> Based on AAL's own forecasts and agreements with airlines, it believes that the forecasts used in this pricing proposal appear to be conservative and that the growth rates should be around 15 per cent higher.
>
> The compound annual growth rate (CAGR) for MTOA at Adelaide for the last 7 years is 4.8 per cent. This period includes relatively low growth in the last two years due to the GFC and a material shift in the fleet mix as airlines have moved to newer and more efficient aircraft.
>
> The long term CAGR for passenger traffic at Adelaide is 5.7 per cent (22 years), and 7.2 per cent for the last 7 years. In the light of these actual growth numbers, the IATA passenger CAGR

[20] Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 1.

of 3.5 per cent appears to be very low. This lends support to the AAL view that the MTOW CAGR is also very conservative.[21]

6.1.3 Airservices' response on activity forecasts

Airservices did not provide any comments on the ACCC's preliminary view on activity forecasts.

6.1.4 ACCC's final view on activity forecasts

The ACCC reaffirms its preliminary view that the use of generalised growth rates is a reasonable method of developing aggregate activity forecasts across Airservices' network. However, the ACCC also acknowledges that these activity forecasts are likely to be more accurate at the aggregate level than at an individual airport level. The ACCC therefore re-iterates its view that Airservices should continue to consult with airports and users on whether alternative risk-sharing arrangements would be appropriate for some individual airports.

7 Building-block model

This section discusses the following issues:

- operating costs (section 7.1)
- opening asset base (section 7.2)
- capital expenditure (section 7.3)
- return of capital (depreciation) (section 7.4)
- rate of return on capital (WACC) (section 7.5)

7.1 Operating costs

Table 7.1 below sets out the estimated operating cost components, together with the average relative contribution towards total operating costs, that were outlined in Airservices' draft price notification.

[21] Adelaide Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

Table 7.1: Airservices' estimated operating costs ($million) and proportion of total operating costs (per cent) over the five years

Operating cost component	2011-12	2012-13	2013-14	2014-15	2015-16	Total	% of costs
Staff costs	512	535	562	587	607	2 803	76.5%
Supplier costs	159	167	171	175	187	859	23.6%
Total staff and supplier costs	**671**	**702**	**732**	**762**	**794**	**3 662**	**100.0%**

Source: Airservices Australia, *Draft price notification,* March 2011, p. 29.

7.1.1 ACCC's preliminary view on operating costs

The ACCC's preliminary view was that the proposed level of operating costs was considered reasonable. The ACCC noted that it had assessed the level of Airservices' staff costs using benchmarking studies and comparisons with other relevant businesses where available, and these indicated that the levels of costs did not appear to be unreasonably high. Further, the ACCC noted that increases in supplier costs related to new or increased levels of service and capital expenditure.

However, the ACCC also noted that Airservices' commitment to improving its formal efficiency targets and KPIs (discussed in section 5) would provide incentives for Airservices to operate efficiently and ensure that its operating costs do not increase beyond reasonable levels in future periods.

7.1.2 Views of interested parties on operating costs

Air New Zealand stated its support for the ACCC's preliminary view that Airservices should improve its operating expenditure efficiency drivers.[22]

Cathay Pacific Airways agreed with the ACCC's preliminary view that there is scope for Airservices to improve its drivers of efficiency through internal benchmarking and setting of explicit efficiency targets.[23]

The RAAA submitted that it 'supports the views expressed by the ACCC in that Airservices needs to be seen as transparent and accountable in their dealings with all stakeholders on all levels of their operations whether operational or capital in nature.[24]

The Qantas Group also agreed that the Service Charter should be expanded to cover cost efficiency KPIs which could be used as an ongoing driver of efficient operations.

VAA submitted that it was 'very supportive of Airservices' decision to develop a Services Charter'. VAA noted:

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[22] Air New Zealand, *Submission in response to the ACCC's preliminary view*, 1 August 2011, p. 1.

[23] Cathay Pacific Airways, *Submission in response to the ACCC's preliminary view*, 29 July 2011, p. 1.

[24] RAAA, *Submission in response to the ACCC's preliminary view*, 27 July 2011, p. 1.

> VAA are particularly pleased to note that the performance framework within the Services Charter aligns with ICAO performance objectives which are to establish and measure performance
>
> …
>
> Along with other industry stakeholders, VAA recognises that it will take time for the Key Performance Indicators to be refined. VAA has accepted an invitation from Airservices to work collaboratively on developing appropriate KPIs over the next 12 months. [25]

Gold Coast Airport stated that 'ARFF and Tower services are currently oversupplied'. In particular, Gold Coast Airport submitted that:

> Gold Coast Airport ARFF requires Category 8 services for the first few hours of the day to cater for larger aircraft. However, Category 8 services are provided for the full operational hours at 17 hours per day. This is inefficient.
>
> …
>
> Benchmarking like towers with like towers and like fire station categories with like fire station categories and explaining why the price difference exists other than traffic volumes. Airservices needs to demonstrate why there is a marked increase or discrepancy in price with locations providing similar levels of service.[26]

7.1.3 Airservices' response on operating costs

Airservices did not provide any comments on the ACCC's preliminary view on operating costs. However, as discussed in section 5 of this document, Airservices did provide further information on its commitment to improving its formal efficiency targets and KPIs.

7.1.4 ACCC's final view on operating costs

The ACCC notes the specific concerns raised by Gold Coast Airport that there is an oversupply of ARFF and TN services at that location and there is a discrepancy in price with locations providing similar levels of service.

As noted in the ACCC's preliminary view, Airservices is required by regulation to provide particular levels of TN and ARFF services when passenger or aircraft movements exceed certain thresholds. Airservices noted in its draft price notification that:

> … an increase in activity may lead to a large increase in costs if air traffic tower of ARFF services and facilities are required at an airport where these services were not previously required.
>
> It is also relevant to note that part of the reason that CASA may require a service to be provided despite most users being unwilling to pay for that service is that CASA's cost benefit analysis may be capturing externality benefits. For example, the value of life that CASA applies to avoiding accidents may include the value to people other than the users who pay the charges.

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[25] Virgin Australia Airlines, *Submission in response to the ACCC's preliminary view*, 1 August 2011, p. 4.

[26] Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

> CASA may also take the view that the aviation industry generally benefits from reductions in air traffic accidents – not just users at airports where accidents are avoided.

The ACCC has assessed the level of staff and supplier costs at Gold Coast Airport against airports providing similar levels of services. These comparisons indicate that the levels of costs at Gold Coast Airport do not appear to be unreasonably high. Further, the ACCC has assessed the structure of pricing in section 8 of this document. The ACCC has found that the methodology used by Airservices to allocate and recover its costs through prices is appropriate.

Therefore, the ACCC's views on operating costs as outlined in its preliminary view remain. As discussed in section 5, Airservices' commitment to improving its formal efficiency targets and KPIs, should provide incentives for Airservices to ensure that its operating costs do not increase beyond reasonable levels in future periods.

7.2 Opening asset base

7.2.1 ACCC's preliminary view on opening asset base

In its preliminary view, the ACCC endorsed Airservices' approach to establishing its opening value of assets based on the values assessed in its 2004-05 LTPA, taking into account new investment based on actual costs and associated depreciation.

The ACCC was prepared to accept Airservices' proposed opening value of assets of $865 million. The ACCC was satisfied that Airservices had not included asset revaluations in its asset base for the purposes of calculating its opening values of assets. Further, the ACCC was satisfied that the movement in the value of assets represents costs that had been incurred by Airservices. Finally, the ACCC did not have concerns with the useful lives applied by Airservices for the purposes of calculating depreciation.

The ACCC noted, however, that it expects that Airservices will provide a detailed reconciliation of its proposed opening value of assets in future LTPAs, including an analysis of how actual capital expenditure (and associated depreciation) compares to that projected in this LTPA.

7.2.2 Views of interested parties on opening asset base

IATA raised concerns about the level of depreciation applied by Airservices in rolling forward its asset base from its 2004-05 LTPA. In particular, IATA submitted that:

> IATA urges the ACCC to review in more detail AsA's actual depreciation versus forecast in the LTPA 2005-09 period as IATA believes that the former has been substantially lower. Given that charges are set on the basis of forecast depreciation, this differential implies that airspace users have been overcharged during the LTPA 2005-09 period potentially by around AUD90 million.
>
> It should be noted that neither the Draft notification nor the ACCC documents provide a detailed year-by-year comparison between the actual and forecast levels of depreciation for the LTPA 2005-09 period. Such table is necessary in order to clarify our concerns.
>
> Unlike "operating costs" were (sic) differences can allegedly be attributed to outperformance, large changes in depreciation can rarely be considered as such particularly given the fact that the delivered capital expenditure has been similar to that proposed in the LTPA.

As previously stated, there are two options for dealing for dealing with this overcharged amount:

(a) implement a revenue claw back in favour of users, or
(b) adjust (i.e. reduce) the opening asset base using the notional depreciation values presented in the LTPA 2005-09.[27]

7.2.3 Airservices' response on opening asset base

Airservices did not provide any comments on the ACCC's preliminary view on opening asset base.

7.2.4 ACCC's final view on opening asset base

The ACCC notes the specific concerns raised by IATA regarding the level of depreciation applied by Airservices in rolling forward its asset base. As outlined in the discussion of return of capital (depreciation) (section 7.4), the ACCC does not have concerns with the useful lives applied by Airservices for the purposes of calculating depreciation and, therefore, rolling forward the asset base. Importantly, the useful lives applied by Airservices for this purposes is based on the economic useful lives of assets.

The economic useful lives of assets differ, in some instances, from the useful lives applied for accounting purposes. For example, the economic useful life of a control tower is 20 years, however the useful life for accounting purposes is 30 years. Notably, the value of assets and level of depreciation reported in Airservices' annual financial accounts, to which IATA has referred, is based on accounting figures and, therefore, differ from those used to roll forward the asset base for the LTPA. The ACCC also notes that asset revaluations, which are included in Airservices' annual financial accounts, are not included in the regulatory asset base and are not passed on in charges.

The ACCC confirms its preliminary view that it accepts Airservices' proposed opening value of assets of $865 million. The ACCC required several iterations of supplementary information from Airservices in order to reach this conclusion. For future LTPAs, the ACCC expects that Airservices will provide a detailed reconciliation of its proposed opening value of assets in the first instance. In particular, the ACCC expects that Airservices will be able to demonstrate how actual capital expenditure (and associated depreciation) compares to that projected in this LTPA. Further, the ACCC notes that the ability of Airservices to demonstrate its actual costs incurred does not provide it with an automatic right to include it in the rolling forward of its asset base for future LTPAs. The ACCC will also need to be satisfied that those costs have been incurred prudently and efficiently.

7.3 Capital expenditure

Table 7.2 below provides a summary of the proposed capital expenditure that was outlined in Airservices' draft price notification.

[27] International Air Transport Association, *IATA submission in response to the ACCC's preliminary view*, 27 July 2011, p. 3.

Table 7.2: Airservices' proposed capital expenditure ($million)

	2011-12	2012-13	2013-14	2014-15	2015-16
Opening asset balance	865	981	1 066	1 144	1 209
Capital expenditure	205	186	193	186	185
Depreciation	89	102	116	120	128
Closing asset balance	981	1 066	1 144	1 209	1 266

Source: Airservices Australia, *Draft price notification*, March 2011, p. 31.

7.3.1 ACCC's preliminary view on capital expenditure

The ACCC stated in its preliminary view that it requires assurance that Airservices' proposed capital projects are appropriate and represent an efficient allocation of resources. The ACCC also stated that it requires assurance that Airservices is accountable for the delivery of its projects. As discussed in section 5, the ACCC raised concerns about the strength of Airservices' processes that provide it with the necessary incentives to ensure these requirements are met.

The ACCC's preliminary view was that, if Airservices was able to address the concerns raised by the ACCC about the strength of its processes, the ACCC would be minded to accept Airservices' proposed level of capital expenditure.

7.3.2 Views of interested parties on capital expenditure

The views of interested parties on the ACCC's preliminary view on Airservices' proposed level of capital expenditure were discussed in section 5 of this document.

Generally, submissions expressed their support for the ACCC's preliminary view that called for Airservices to improve its processes to ensure that capital expenditure is prudent and efficient, and to provide greater transparency and accountability for the delivery of its projects.

7.3.3 Airservices' response on capital expenditure

As discussed in section 5 of this document, Airservices has committed to improving its consultation with stakeholders to ensure that its capital expenditure is undertaken prudently and efficiently.

Airservices has submitted that these steps will provide greater transparency over, and informed input to, capital project decision making as well as improving the ongoing monitoring of delivery performance.

7.3.4 ACCC's final view on capital expenditure

In section 5 of this document, the ACCC discussed the views of stakeholders and Airservices' response to its preliminary view that Airservices needs to commit to improving its consultation processes to ensure that its capital expenditure is undertaken prudently and efficiently.

The ACCC considers that the commitment made by Airservices to improving its consultation processes constitutes an important step towards addressing the points raised in the preliminary view. The ACCC considers that the proposed process, once implemented, has the potential to provide greater incentives for Airservices to undertake prudent and efficient investment, as well as providing increased accountability for delivering on agreed capital expenditure projects.

The ACCC's final view is to accept Airservices' proposed capital expenditure of $958 million over the five-year period covered by its LTPA. However, as noted above, Airservices' implementation of the consultation process will be relevant to whether the ACCC considers a short form process of assessment of Airservices' annual locality notices to be appropriate.

7.4 Return of capital (depreciation)

Tables 7.3 below provides a summary of the proposed return of capital, together with the annual and total growth costs, that was outlined in Airservices' draft price notification.

Table 7.3: Airservices' proposed return of capital ($million) and growth in return of capital (per cent) over the five years

	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Depreciation	89	102	116	120	128	555
Depreciation cost growth		14.7%	13.7%	4.1%	6.6%	44.7%

Source: Airservices Australia, *Draft price notification*, March 2011, p. 31.

7.4.1 ACCC's preliminary view on return of capital (depreciation)

In its preliminary view, the ACCC stated that it was prepared to accept the useful lives of assets applied by Airservices for the purposes of calculating return of capital. The ACCC noted, however, that if Airservices made an adjustment to its level of capital expenditure when submitting its formal price notification, an associated adjustment would need to be made to the level of return of capital.

7.4.2 Views of interested parties on return of capital (depreciation)

As noted in the above discussion on the opening asset base (section 7.2), IATA raised concerns about the level of depreciation applied by Airservices in rolling forward its asset base from its 2004-05 LTPA.

7.4.3 Airservices' response on return of capital (depreciation)

Airservices did not provide any comments on the ACCC's preliminary view on return of capital (depreciation).

7.4.4 ACCC's final view on return of capital (depreciation)

The ACCC's views on return of capital stated in its preliminary view remain. The ACCC acknowledges the specific concerns raised by IATA in relation to the level of depreciation applied by Airservices in rolling forward its asset base from its 2004-05 LTPA. However, as discussed in section 7.2, the ACCC is satisfied that the level of depreciation applied by Airservices is appropriate.

7.5 Rate of return on capital (WACC)

7.5.1 ACCC's preliminary view on rate of return on capital (WACC)

The ACCC's preliminary view stated that it did not accept Airservices' proposed nominal vanilla WACC of 9.95 per cent on the basis that it did not accept the methodology applied by Airservices. The ACCC's preliminary view was that it was prepared to accept the methodology applied for determining a WACC for Airservices if it was consistent with its 2004-05 assessment. Instead, Airservices sought to change its methodology by changing the credit rating used to estimate its cost of debt.

In its preliminary view, the ACCC applied a methodology consistent with its 2004-05 assessment to estimate a nominal vanilla WACC of 8.37 per cent. The ACCC's preliminary view is explained in further detail below.

The ACCC noted that any adjustment to the WACC needs to be reflected by an associated adjustment to the required revenue and prices for users.

Cost of debt margin

Credit rating

As noted above, Airservices had proposed to leave the methodology for determining its WACC unchanged from that which the ACCC approved in its 2004-05 decision, except that it proposed to base its cost of debt on an AA credit rating where previously it used an AAA rating. The ACCC's preliminary view was that it was prepared to accept the methodology applied for determining Airservices' WACC if it was consistent with its 2004-05 assessment. This included basing the cost of debt on an AAA rating.

Methodology used to estimate the cost of debt margin

The ACCC did not accept Airservices' use of a Bloomberg five-year AA fair value curve (FVC), adding the difference between a five-year and ten-year AAA FVC and subtracting a ten-year nominal risk-free rate, to estimate the cost of debt margin.

In its preliminary view, the ACCC used Bloomberg to obtain data for all AAA fixed rate bonds with a remaining maturity of between four and six years. The five-year nominal risk-free rate was then subtracted from the 20-day average yield to maturity of those bonds to estimate a cost of debt margin of 0.34 per cent. The resultant comparator set was made up of treasury state bonds and one bond from Export Financial and Insurance Corporate (EFIC), which is the Australian Government's export credit agency.

Nominal risk-free rate for estimating the cost of debt

The ACCC did not accept Airservices' use of a 40-day average of the yield to maturity for ten-year bonds to be applied as the nominal risk-free rate used to estimate the cost of debt.

In its preliminary view, the ACCC used Bloomberg to obtain the most recent 20-day average of the yield to maturity for five-year Commonwealth Government securities. The preliminary view noted that a 20-day averaging period was considered appropriate as it was consistent with the ACCC's other recent decisions. Further, a five-year term matched the period covered by Airservices' proposal, stakeholders considered it appropriate and the term was consistent with that proposed by Airservices and applied by the ACCC to estimate the cost of debt margin.[28]

7.5.2 Views of interested parties on rate of return on capital (WACC)

Submissions generally expressed their support for the ACCC's preliminary view on Airservices' proposed rate of return on capital. No submissions raised concern about the ACCC's preliminary view on WACC.

Air New Zealand stated that the reduced allowable revenue be achieved through an immediate reduction in en-route charges.[29]

BARA submitted that:

> BARA would argue that if the Australian Government chooses to allow (or has unofficially directed) AsA to price TN and ARFF services at regional and GA airports below cost but without taxpayer funding, then this should be funded internally through AsA earning a lower rate of return on its assets. (p. 2)
>
> At a minimum, AsA's allowable revenues should be reduced by setting the WACC earned on the assets at loss making locations at zero. The impact of not allowing AsA to earn a rate of return on loss making assets would be about $10 million to $12 million per year. AsA could still make a dividend payment to the Australian Government and earn a rate of return (in fact an excessive rate on average) on its profitable activities, while at least having some regard to its policy of pricing TN and ARFF services below cost at many regional and GA airports.[30]

BARA also stated that it considers that the reduction in allowable revenues through a lower WACC should be realised through a reduction in en-route prices. In particular:

> By reducing the en-route price, it ensures that a greater proportion of the allowable revenue reduction benefits those who are overcharged the most, namely international airlines. This proposal does not mean that BARA accepts the proposed structure of TN or ARFF prices as

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[28] As discussed above, Airservices proposed the use of a Bloomberg five-year AA fair value curve in its estimation of the cost of debt margin.

[29] Air New Zealand, *Air Submission in response to the ACCC's preliminary view*, 1 August 2011, p. 1.

[30] BARA, *Submission in response to the ACCC's preliminary view*, 28 July 2011, pp. 2-3.

> reasonable. Rather, it represents a practical compromise given the existing economic regulatory arrangements, especially the lack of appeal rights compared to Part IIIA.[31]

Emirates submitted that it agrees with the ACCC's view that Airservices' WACC should be adjusted to a more appropriate level, which would generate an allowable revenue reduction of $101 million over five years.[32] Emirates also stated that:

> Given significant overcharging remains on enroute services and specifically on oceanic sectors, any reduction in allowable revenues should be applied as a unit rate reduction to enroute charges. This would at a minimum acknowledge the cross-subsidisation between service lines.[33]

Gold Coast Airport stated its support for Airservices to review its methodology.[34]

IATA supported the ACCC's proposed solutions to address these concerns such as the provision of detailed information on a project-by-project level and the reduction of the required revenue by about $100 million from applying a cost of capital that truly reflects Airservices' risks.[35]

Qantas expressed its support for the ACCC's preliminary view, submitting that:

> 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%.[36]

VAA noted that it had previously submitted that the methodology used by Airservices in calculating the WACC was too high. VAA noted that, as Airservices is not exposed to a high level of commercial and competitive risk being a government-owned provider, the debt margin used in the WACC calculation appeared too high. VAA welcomed the ACCC's decision in not accepting Airservices proposed rate of return on capital as appropriate.[37]

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31 ibid., p. 3.

32 Emirates, *Submission in response to the ACCC's preliminary view*, 31 July 2011, p. 1.

33 Emirates, *Submission in response to the ACCC's preliminary view*, 31 July 2011, p. 3.

34 Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

35 IATA, *Submission in response to the ACCC's preliminary view*, 27 July 2011, p. 2.

36 Qantas Group, *Submission in response to the ACCC's preliminary view*, 29 July 2011, p. 4.

37 VAA, *Submission in response to the ACCC's preliminary view*, 1 August 2011, p. 5.

7.5.3 Airservices' response on rate of return on capital (WACC)

Airservices submitted that it had reviewed the nominal risk-free rate and cost of debt margin in response to the ACCC's preliminary view. As discussed in more detail below, Airservices has essentially used the same methodology for estimating its WACC (based on an AA credit rating) that its draft price notification used. However, Airservices' formal price notification proposes a lower WACC because Airservices no longer proposes to add a premium to a five-year estimate of the cost of debt margin as a means of estimating a ten-year rate. Also, interest rates fell between the draft and formal price notifications.

Table 7.4 summarises the WACC parameters proposed by Airservices in its draft price notification and those proposed in its formal price notification.

Table 7.4: Airservices' proposed WACC parameters

WACC parameter	Airservices' DRAFT price notification	Airservices' FORMAL price notification
Nominal risk free rate (R_f)	**5.58%**	**4.96%**
Debt margin (d_m)	**2.37%**	**1.95%**
Market risk premium (R_m - R_f)	6.00%	6.00%
Corporate tax rate (T_c)	30.00%	30.00%
Dividend imputation (γ)	50.00%	50.00%
Gearing ratio (D/V)	45.00%	45.00%
Asset beta (β_a)	0.55	0.55
Debt beta (β_d)	0.00	0.00
Equity beta (β_e)	1.00	1.00
Cost of debt (R_d)	**7.95%**	**6.91%**
Cost of equity (post tax nom) (R_e)	**11.58%**	**10.93%**
Nominal vanilla WACC	**9.95%**	**9.12%**

The following provides a summary of Airservices' revised proposal. Airservices' full response to the ACCC's preliminary view on WACC is available in attachment 2 to Airservices' formal price notification, pp. 14-29.

Cost of debt margin

Credit rating

Airservices has submitted that an AA credit rating should be applied in this price notification. Airservices stated that a business with its characteristics is likely to have a benchmark credit rating in the range of AA to A-. This is based on the fact that Airservices' 'stand-alone' credit rating is AA and an A- credit rating has been applied by Standard & Poor's (S&P) and the UK regulator to the UK air services provider (NATS).[38]

With respect to the use of its stand-alone credit rating, Airservices has submitted that this is consistent with the 'Commonwealth Competitive Neutrality Policy Statement' of June 1996, which states that:

> All Commonwealth organisations identified as engaging in significant business activities will be required to earn commercial returns at least sufficient to justify the long-term retention of assets in the business, and to pay commercial dividends (i.e. equivalent to the average for their industry) to the Budget from those returns … Regulatory neutrality will be achieved by subjecting, where appropriate, all identified organisations to the same regulatory environment as private sector businesses.[39]

Methodology used to estimate the cost of debt margin

Airservices has used the Bloomberg five-year AA FVC and assumed that the cost of debt margin is constant between five and ten years. Airservices has submitted that this results in a conservative estimate of the ten-year cost of debt margin of 1.95 per cent.[40]

Alternative options for estimating the cost of debt margin

In its supporting material, Airservices has also outlined a number of alternative options for estimating the cost of debt margin, using AAA and AA rated benchmarks. The alternative options apply a combination of extrapolation of five-year AAA and AA rated FVCs and averaging of AAA and AA rated bonds.

Airservices has submitted that these alternative options result in an estimated ten-year cost of debt margin of between 1.22 per cent and 1.91 per cent, with an average estimate of 1.59 per cent.[41]

Nominal risk-free rate for estimating the cost of debt

Airservices has used a 20-day average of the yield to maturity for ten-year bonds to the end of 5 August 2011, resulting in a nominal risk-free rate of 4.96 per cent. Airservices submitted that this is consistent with the term that it has used to estimate the cost of debt margin and is also consistent with that applied to the market risk premium (MRP) to estimate the cost of equity.[42]

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[38] A stand-alone credit rating refers to the credit rating that Airservices submits it would be afforded if it wasn't a 100 per cent government-owned entity. Airservices submits that implicit in a credit rating of AAA is a guarantee from the government. Airservices Australia, *Formal price notification*, 22 August 2011, p. 14.

[39] Airservices Australia, *Formal price notification*, 22August 2011, pp. 18-19.

[40] Airservices Australia, *Formal price notification*, 22 August 2011, pp. 14-15.

[41] Airservices Australia, *Formal price notification*, 22 August 2011, p. 26.

[42] Airservices Australia, *Formal price notification*, 22 August 2011, p. 15.

7.5.4 ACCC's final view on rate of return on capital (WACC)

As discussed in section 7.5.1, the ACCC's preliminary view assessed that the WACC proposed by Airservices was too high.

In its draft price notification, Airservices had proposed to leave the methodology for determining its WACC unchanged from that which the ACCC approved in its 2004-05 decision, except that it proposed to base its cost of debt on an AA credit rating where previously it used an AAA rating. The ACCC's preliminary view was that it was prepared to accept the methodology applied for determining Airservices' WACC if it was consistent with its 2004-05 assessment. This included basing the cost of debt on an AAA rating. The ACCC notes that submissions expressed support for its preliminary view.

In its formal price notification, Airservices has based its cost of debt on an AA credit rating. As such, Airservices' formal price notification has essentially used the same methodology for determining its WACC that its draft price notification used. However, its revised WACC of 9.12 per cent is 0.83 per cent lower than its draft price notification because Airservices no longer proposes to add a premium to a five-year estimate of the cost of debt margin as a means of estimating a ten-year rate. Also, interest rates fell between the draft price notification and the formal price notification.

The ACCC considers that Airservices has not addressed the comments in its preliminary view that, in the context of this price notification, it was prepared to accept the methodology applied for determining a WACC for Airservices if it was consistent with its 2004-05 assessment. Instead, Airservices has sought to change one component of its methodology by changing the credit rating used to estimate its cost of debt.

Further, the ACCC has considered Airservices' comments that its stand-alone rating of AA should be applied in this price notification, having submitted that this is consistent with the concept of competitive neutrality. The ACCC does not consider that applying an AA rating, and excluding AAA measures, on the basis of the concept of competitive neutrality is consistent with the previous methodology.

For the reasons outlined above, the ACCC objects to Airservices' proposed WACC of 9.12 per cent.

The ACCC confirms in this final decision that it would not object to a WACC for Airservices based on the methodology applied in its 2004-05 assessment, which includes basing the cost of debt on an AAA rating.

However, the ACCC acknowledges that the estimated AAA cost of debt margin of 0.34 per cent in its preliminary view may have been too low. In particular, as noted by Airservices in its draft and formal price notifications, there is limited data available for bonds with a ten-year term to maturity. Therefore, in its preliminary view, the ACCC used an average of the available AAA rated bonds with a term to maturity of between four and six years to estimate a cost of debt margin. However, the resulting set of bonds was dominated by treasury bonds, which are not representative of an AAA rated firm with the commercial characteristics of Airservices.

Therefore, in estimating the cost of debt margin for this final view, the ACCC has sought to use non-treasury bonds. However, due to the limited non-treasury bond data available for bonds with a ten-year maturity, and indeed five-year maturity, the ACCC has considered a wider term to maturity of three to seven years. The ACCC has also considered AA+ and AA rated bonds to increase the sample size.

This approach has resulted in an estimated cost of debt margin of 1.31 per cent. This has been estimated by subtracting the five-year nominal risk free rate, being 4.50 per cent, from the average yield to maturity of all non-treasury AAA, AA+ and AA rated bonds with a term to maturity of between three and seven years. For both the nominal risk free rate and cost of debt margin, the ACCC has used a 20-day averaging period finishing on 5 August 2011, which is the averaging period nominated by Airservices in its formal price notification. This comparator set comprised 33 bonds from eight different firms.

Applying a cost of debt margin of 1.31 per cent and a five-year nominal risk-free rate to the cost of debt results in a nominal vanilla WACC of 8.60 per cent.[43]

The ACCC has also considered its decision on final access determinations for the declared fixed lines services (the FAD decision) that was released in July 2011. In the FAD decision, the ACCC found that a WACC of 8.54 per cent was appropriate for Telstra, which has a similar gearing level to Airservices and whose debt is rated as A.[44] This suggests that a WACC of 8.60 per cent, noting that interest rates have decreased since the FAD decision, is not an unreasonable estimate for a firm with a cost of debt based on an AAA rating.

In summary, the ACCC does not accept Airservices' proposed WACC of 9.12 per cent. The ACCC would not, however, object to a WACC of no higher than 8.60 per cent.

The ACCC notes that an adjustment to the WACC needs to be reflected by an associated adjustment to the required revenue and prices for users. Table 7.5 below shows the effect of this revised WACC on Airservices' required revenue.

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43 A five-year risk-free rate of 4.50 per cent was applied to the cost of debt. In all cases, the ACCC has used a 20-day averaging period finishing on 5 August 2011, which is the averaging period nominated by Airservices in its draft price notification. The other WACC parameters applied were as follows: cost of debt margin = 1.31 per cent (based on an AAA rating); gearing = 45 per cent; asset beta = 0.55; equity beta = 1.00.

44 The FAD decision applied a nominal vanilla WACC of 8.54 per cent based on the following WACC parameters: nominal risk-free rate = 5.16 per cent; cost of debt margin = 2.06 per cent (based on an A rating); gearing = 40 per cent; equity beta = 0.70.

Table 7.5: ACCC's assessment of the effect of a variation in the WACC on Airservices' proposed required revenue ($million)

	Airservices' DRAFT proposal	Airservices' FINAL proposal	ACCC's FINAL decision
	9.95%	9.12%	8.60%
2011-12	862	853	847
2012-13	917	907	900
2013-14	970	960	953
2014-15	1 013	1 002	994
2015-16	1 060	1 048	1 040
Total	4 821	4 769	4 734

The ACCC has not specified in this final decision what the prices should be, based on this revised revenue, because of the complex range of prices that Airservices has notified. As noted in section 8, the ACCC considers that Airservices has the incentive to structure prices in a way that promotes efficiency and is in the best position to determine what the prices should be.

8 Pricing and structure of prices

The ACCC's approach to the assessment of Airservices' pricing and structure of prices, as outlined in its preliminary view, is at **appendix E**.

This section discusses the following issues:

- allocation of costs (section 8.1)
- pricing across services and locations (section 8.2)
- basis of charges (weight based charges) (section 8.3)
- other basis of charges issues (section 8.4)
- timing of recovery of capital costs (section 8.5)

8.1 Allocation of costs

8.1.1 ACCC's preliminary view on allocation of costs

In its preliminary view, the ACCC noted that Airservices' method of allocation of fixed and common costs was relatively uncontroversial amongst stakeholders, and its view remained consistent with its 2005 decision.

8.1.2 Views of interested parties on allocation of costs

IATA questioned Airservices' implementation of its cost allocation method in the context of more general concerns related to cross subsidies. As such, IATA's comments have been addressed in this section and in section 8.2 below.

8.1.3 Airservices' response on allocation of costs

Airservices did not provide any additional comments in relation to allocation of costs.

8.1.4 ACCC's final view on allocation of costs

The ACCC notes that, as part of its assessment process, it has ascertained that Airservices has allocated its costs according to its cost allocation methodology, as described on pp. 45-48 of its draft price notification. This includes allocating direct costs to locations for TN and ARFF services. Airservices retained the approach taken in its 2004-05 LTPA to the allocation of common costs on the basis of activity. Cost allocation forms the basis of its pricing decisions in the first instance (prior to any price caps being applied) and is consistent with the inverse elasticity rule.[45] The ACCC, as noted in its preliminary view, considers Airservices' application of this inverse elasticity method to be appropriate.

However, as a result of Airservices applying price caps to some services, revenues from some service locations do not recover their incremental cost, while there is over-recovery of costs in other areas. The structure of prices to recover costs is discussed in greater detail in section 8.2 below.

The ACCC's reiterates its preliminary view that it considers Airservices' allocation of costs to be reasonable.

8.2 Pricing across services and locations

8.2.1 ACCC's preliminary view on pricing across services and locations

In its preliminary view, the ACCC noted that Airservices' proposed structure of pricing across services and locations was largely unchanged from that which was implemented in the 2004-05 LTPA. On this basis, the ACCC considered that Airservices' pricing structure across services and locations appeared to be reasonable.

The ACCC noted that Airservices' hybrid pricing model involved a degree of under- and over-recovery of costs for certain services and for services in certain locations, however, the ACCC did not consider that the pricing structure that had been implemented by Airservices raised concern from an efficiency perspective.

[45] The inverse elasticity method of cost allocation involves allocating common costs between users with the objective of maximising efficiency. In circumstances where demands for services produced by a multi-product monopolist are independent (i.e. where the cross-price elasticities of demand are zero), allocating common costs in inverse proportion to various users' price elasticities of demand will maximise economic welfare.

The ACCC noted the additional information provided by Airservices in relation to basin pricing. The ACCC's view in relation to basin pricing was consistent to that regarding price structure more generally.

8.2.2 Views of interested parties on pricing across services and locations

Pricing structure and the recovery of costs across services and locations

IATA considered that cross subsidies from en route to TN and ARFF services are designed to favour certain segments of users, such as GA. IATA considered that it should be up to the ANSP owner (the Government) to cover the costs of any subsidies it wishes to provide to user segments. IATA also considered that it would be fair to forgo the cost of capital related to the provision of subsidised services.

Further IATA stated that there was no proof that only common costs had been distributed through the application of Ramsey pricing by Airservices. IATA called on the ACCC to ensure that 'the cross subsidies allowed in the price notification are consistent and follow this principle'.

IATA also noted that, although the level of the cross subsidy from en route to TN and ARFF services decreased over the period of the proposed LTPA, the cross subsidy within TN and ARFF services across locations increased.[46]

Air New Zealand stated that the ACCC's approach did little to address the continuation of cross subsidies between services and between locations. Air New Zealand considered that concerns regarding the impact on demand in regional and GA locations should be addressed 'separately from Airservices' commercial pricing structure, which should be focused on ensuring customers are paying for only those services they require and use, as would be the case in a competitive market'.[47] Air New Zealand also called for a reduction in en route charges in the case that Airservices' allowable revenue is revised down, as foreshadowed in the ACCC's preliminary view.

Other stakeholders (RAAA, Adelaide Airport, Rex) opposed location-specific pricing, and advocated a return to network pricing.

Adelaide Airport was opposed to location-specific pricing on the basis that there should not be a cost differential for identical services provided in different locations. Adelaide Airport argued that pricing according to local traffic volumes had the effect of encouraging traffic at airports with the highest volumes and discouraging use of airports with lower traffic volumes and unused capacity.

Adelaide Airport argued that the services are non-discretionary and therefore impose costs that discourage the provision of aeronautical services to regional Australia.

Further, it argued that location-specific pricing puts smaller regional airlines at a disadvantage as they do not have the ability to 'pick and choose' how they service the

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46 IATA, *Submission in response to the ACCC's preliminary view*, 27 July 2011, pp. 2-3.

47 Air New Zealand, *Submission in response to the ACCC's preliminary view*, 1 August 2011, p. 1.

higher-cost airports as the major airlines do. It also stated that location-specific pricing is in opposition to the Government's stated strategy to encourage international airlines to increase services to Australia's secondary international gateways as per the National Aviation White Paper.

Adelaide Airport contended that under location-specific pricing, Airservices has no incentives to manage the provision of services efficiently on a location basis. Airservices, it stated, would be indifferent to the level of costs at each location if it can recover costs on a location basis rather than ensuring the efficiency of the network as a whole.

RAAA reiterated its view that network-based pricing would ensure greater equity for regional operators and the communities that they service.[48]

Rex expressed concerns about the impact of location-specific pricing on regional airlines and the potential for regional air services to decline if moves towards cost reflective and location-specific pricing are made.[49]

Issues raised by BARA in relation to the ACCC's interpretation of the CCA about the recovery of costs

BARA raised the following concerns in its submission to the ACCC's preliminary view:

- The ACCC had placed the implicit financial obligations contained in the *Airservices Act 1995* before its own legislative objectives, as contained in the CCA.
- The ACCC is allowing Airservices to use its market power in the setting of TN and ARFF prices at major international airports so Airservices can fulfil an implicit policy objective of aggregate cost recovery. BARA stated it was unconvinced that the ACCC in 'effectively moving to an aggregate "revenue cap" arrangement in assessing [Airservices'] prices' is adequately discharging its legislative obligations.[50] In particular, BARA referred to subsection 95G(7)(b) of the CCA, which requires the ACCC to 'discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that market power in setting prices'. Relevant to this point, BARA noted that different markets are served by individual airports and that the market cannot be defined simply as the market for TN or ARFF services.
- The ACCC appeared to define the situations in which it would seek to discourage Airservices' market power in price setting. BARA considered that

48 RAAA, *Submission in response to the ACCC's preliminary view*, 27 July 2011, p. 1.

49 Regional Express, *Submission in response to the ACCC's preliminary view*, 2 August 2011, pp. 1-2.

50 BARA, *Submission in response to the ACCC's preliminary view*, 28 July 2011, p. 2.

the ACCC's obligations under the CCA do not provide for 'such regulatory discretion with regard to a person taking advantage of its market power'.[51]

- The ACCC's position would be overturned by the Australian Competition Tribunal if the same appeal rights existed for price notifications as exist under Part IIIA of the CCA.

BARA stated that if Airservices is to price TN and ARFF services at regional and GA airports below cost, then it should earn a lower rate of return on its assets. BARA suggested that at a minimum, Airservices' allowable revenues should be reduced by setting the WACC earned on the assets at loss making locations at zero. BARA estimated that the impact of this would be $10 million to $12 million per year, allowing Airservices to earn a rate of return on its profitable activities while having regard to its policy of pricing TN and ARFF services below costs at many regional and GA airports.

8.2.3 Airservices' response on pricing across services and locations

Airservices did not provide any additional comments in relation to pricing across services and locations.

8.2.4 ACCC's final view on pricing across services and locations

Pricing structure and the recovery of costs across services and locations

The ACCC's approach to assessing pricing structure

The ACCC's approach to assessing pricing structure was set out in its preliminary view and is reproduced in appendix E. Generally, the ACCC is reluctant to prescribe individual charges at too fine a level of detail. This is based on the premise that Airservices possesses greater motivation and information than third party arbiters to determine price structures that best recover cost and maximise network usage.

Nevertheless, the ACCC does employ some tests of costs to gain a level of comfort with the efficiency of proposed prices. Generally setting prices for a service below incremental cost may encourage inefficient over-use of that service, while setting prices above stand-alone costs could provide Airservices with monopoly returns.[52]

As identified in its preliminary view, the ACCC would consider under-recovery of costs for a service or at a location to be of concern from an efficiency perspective if:

- there were the prospect of competition being introduced to the service, or

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51 BARA, *Submission in response to the ACCC's preliminary view*, 28 July 2011, p. 3.

52 ACCC, *Airservices Australia draft price notification; Preliminary View*, July 2011, pp. 56-57.

- the level of prices at GA or regional airports were low such that airports were being kept open when the value of these airports to their users is less than the cost of the airports.[53]

However, the ACCC's preliminary view was that it had not been provided with evidence that either of these situations applied. Therefore, in assessing Airservices' structure of prices, the ACCC has focused on those situations where there is evidence that a proposed pricing structure is likely to create distortions in demand, or where there are clear opportunities for more equitable outcomes through pricing without creating such distortions. The reasons for this approach are detailed in the preliminary view.[54]

Further, the ACCC has also given consideration to the requirement for Airservices, as a single provider directed or required by safety regulations, to service all airports. Notably, the Civil Aviation Safety Authority (CASA) is the regulatory agency responsible for safety. CASA regulations require Airservices to provide services at airports when passenger or aircraft movements exceed certain thresholds. As such, Airservices does not have discretion about what level services are provided and the ACCC has taken into account Airservices' recovery of it full efficient costs.

The ACCC's views on pricing structure

Airservices employs a hybrid pricing model. This pricing model goes some way to making prices reflective of costs, but recognises that pure location-specific pricing may not currently be viable given Airservices' mandate to provide services at any location as directed by CASA and to recover costs across its entire network.

Location-specific pricing does not afford Airservices the opportunity to set prices at each location without regard to the impact of those prices on its ability to recover its costs. The ACCC notes that Airservices' revenues are constrained as a result of the price notification process. This process provides several checks on the efficiency of Airservices' expenditure and costs. In addition, Airservices is required to provide information to the ACCC regarding the costing for each service at each location. The ACCC does not consider that a network pricing model provides incentives for Airservices to achieve efficiency gains. On the contrary, removal of price signals completely through network pricing does not support allocative or productive efficiencies, and is more likely to result in distortions in demand that could impair Airservices' ability to provide services and recover its costs across its entire business. Further, the network pricing model would represent a further subsidisation of smaller airports.

The ACCC has stated in its preliminary view that it accepts Airservices' approach to pricing across services and locations, on the premise that alternative pricing structures would have the potential to create distortions in demand. As noted above, however,

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53 ACCC, *Airservices Australia draft price notification; Preliminary View*, July 2011, p. 68.

54 ACCC, *Airservices Australia draft price notification; Preliminary View*, July 2011, pp. 56-59 and pp. 67-69.

there is a limit to the degree of under-recovery that the ACCC would consider to be acceptable.

The ACCC acknowledges the concerns raised by interested parties about the under- and over-recovery of costs from some service lines, or at some locations. In this respect, the ACCC takes into account the impact of Airservices' prices on users at individual airport locations. However, as discussed above, the ACCC must also take into consideration that Airservices is required by regulations to provide certain levels of service at airports. Further, the ACCC considers that it is not unreasonable for Airservices to be able to recover its full efficient costs of providing services across its entire network. This is appropriate given that there is no current policy to introduce competition to Airservices services.

The ACCC does not consider unreasonable Airservices' contention that a move to full cost recovery at all locations would lead to distortions in demand. Further, such a move may impact on the business's capability to provide services at those and other locations. Similarly, this could occur if Airservices were to make continued losses at currently subsidised locations. The ACCC also notes a lack of evidence that over-recovery of costs is distorting demand for any services, or at any locations.

The ACCC also acknowledges the increase in the level of under-recovery of costs for TN and ARFF services at some locations over the period of the proposed LTPA. As noted in the ACCC's preliminary view, Airservices advised that the increased under-recovery of costs can be attributed to regulatory changes. Airservices further advised that the increased under-recovery did not represent a trend beyond the proposed LTPA. The ACCC noted that it expected a move towards recovery of costs by regional and GA airports would continue to occur. The ACCC reiterates this view, to the extent that such moves do not distort demand for services at those locations.

Finally, the ACCC notes concerns that the potential for inequity across user groups, and users at different locations, may arise as a result of over-recovery of costs for some services and at some locations. As discussed above, the ACCC considers Airservices' hybrid pricing model is appropriate given Airservices' mandate to provide services at any location as directed and to recover costs across its entire network, together with the potential for distortions resulting from a move to pure location-specific pricing at this time.

Issues raised by BARA in relation to the ACCC's interpretation of the CCA about the recovery of costs

BARA has expressed concerns regarding the ACCC's interpretation and application of subsection 95G(7) of the CCA as described above.

As outlined in appendix D, in exercising its powers and performing its functions, subsection 95G(7) of the CCA requires the ACCC to have particular regard to the need to:

a) maintain investment and employment, including the influence of profitability on investment and employment

b) discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices

c) discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The ACCC's role is to assess proposed price increases for notified services. The ACCC can object to the price increases, not object to the price increases, or not object to increases lower than those proposed. As set out in appendix D, the ACCC considers that the criteria in subsection 95G(7) will generally be met by economically efficient prices that reflect an efficient cost base and a reasonable rate of return on capital.

The ACCC considers that including a reasonable rate of return on capital will address the criterion in paragraph 95G(7)(a) by providing incentives to maintain profitable investment. At the same time, this will discourage a declared firm from charging prices based on profits greater than the reasonable rate of return, as per the criterion in paragraph 95G(7)(b), which addresses issues relating to market power that the firm may have in the market for notified goods and services.

The ACCC's legal obligations in the assessment of Airservices' price notifications

In its preliminary view, the ACCC stated that it was required to examine Airservices' draft price notification taking the policy parameters in which it operates as given. The ACCC noted that the absence of any policy for Airservices' (regulated) services to be taxpayer funded indicated a requirement for Airservices to recover costs across its entire (regulated) business. BARA contended that the ACCC, in taking this approach, was placing the implicit financial obligations contained in the Airservices Act above its own legislative objectives, as contained in the CCA.

The ACCC does consider the Airservices Act in determining the broader framework of any price notification lodged with the ACCC. The Airservices Act provides the context in which Airservices provides its services, and sets out its powers, functions and obligations. In determining economically efficient prices that reflect an efficient cost base and a reasonable rate of return, the ACCC will have regard to the functions and obligations of Airservices under the Airservices Act.

In assessing Airservices' proposal, the ACCC has applied the building block model to estimate required revenues, taking account of the costs of providing the service, and incorporating a reasonable rate of return. Airservices' costs include those of providing regulated services to all locations as directed, or required by safety regulation. The ACCC is prepared to accept Airservices' forecast costs as efficient once it implements its drivers of efficiency and its capital expenditure consultation program (sections 5.4 and 5.5 respectively). On this basis the ACCC does not object to a level of revenues (and therefore prices) that recover the cost of providing that service.

Moreover, it would be inconsistent with subsection 95G(7) of the CCA for the ACCC to disregard the costs of providing certain services in estimating Airservices' required revenues. Importantly, any such decision would imply a redistribution of Government funds, either to fund a revenue shortfall, or reduce dividends that are derived from a reasonable return on investment. Such decisions are a matter for Government. For example, the ACCC notes that in the case of search and rescue services, the Airservices Act under subsection 13(f) makes explicit provision for Airservices to forgo a return on capital. No such provision has been made for any part of Airservices' regulated business, and therefore the ACCC has taken into account Airservices' full efficient costs.

The ACCC does not consider whether Airservices is paying, or should pay, a dividend to the Commonwealth. Under section 46 of the Airservices Act, the Airservices Board must recommend to the Minister to pay a dividend, or not pay a dividend to the Commonwealth. This is a decision for the Board, and then the Minister, based on the Board's recommendation, which occurs annually. It is a neither a decision for, nor a factor that, the ACCC considers in assessing the reasonable rate of return in a price notification.

That said, as discussed above, it is clear that some services at some locations do not recover their costs. BARA's submission goes to who should fund this deficit. Airservices' proposal is that the users of the larger airports pay through an over-recovery of costs. As discussed above, the ACCC has assessed that the potential detrimental effects on the efficient use of Airservices facilities are not significant and, therefore, the ACCC considers that Airservices' pricing across services and locations appears reasonable.

Finally, the ACCC notes BARA's contention that the ACCC's position would be overturned by the Australian Competition Tribunal if appeal rights (such as those that exist under Part IIIA of the CCA) existed for price notifications. The ACCC notes that the potential views of the Tribunal in relation to price notifications are difficult to contemplate given the nature of the prices surveillance provisions, and the ACCC's role in, and response to, assessing price notifications as described above. The ACCC reiterates, however, that its approach to assessing Airservices' locality notices, including prices and pricing structure, is consistent both with the objectives outlined by the Government for pricing infrastructure under the national access regime under Part IIIA of the CCA,[55] and with the object of prices surveillance, as set out in section 95E of the CCA.

In summary, the ACCC's re-iterates its preliminary view that Airservices' pricing across services and locations appears to be reasonable.

8.3 Basis of charges (weight based charges across all services)

8.3.1 ACCC's preliminary view on basis of charges (weight based charges)

MTOW-based charges

The ACCC's preliminary view considered reasonable Airservices' proposed use of MTOW as a basis of charges given that:

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[55] See Commonwealth Government, Government response to Productivity Commission report on the review of the national Access Regime, Canberra, September 2002.

- taking MTOW into account in aircraft navigation charges is generally accepted internationally, and used by a large number of ANSPs.
- it supports efficient pricing structures
- alternative bases of charges, such as those based only on distance or cost of service provision can suffer from a significant level of administrative complexity.

Nonetheless, the ACCC encouraged Airservices to continue to engage with stakeholders, and review its pricing mechanisms during the course of the LTPA to ensure they remain appropriate.

Industry versus company-average MTOW

In its preliminary view, the ACCC considered that the use of an industry average MTOW was reasonable as the benefits associated with more precise charging options may not outweigh the costs resulting from additional administrative complexity involved.

MTOW cap versus less than proportional MTOW-based charging

In its preliminary view, the ACCC considered that the use a 500 tonne weight cap was consistent with efficient pricing principles.

A 500 tonne weight cap was not expected by Airservices to have a substantial impact on most user groups. The ACCC considered, instead, that the use of a power of less than one in the setting of TN and ARFF charges would benefit larger operators, and have a significant negative impact on smaller operators.

In particular, the ACCC considered there was a risk that the use of a power less than one in setting charges for TN and ARFF could run counter to inverse elasticity pricing. That is, it would have the unintended result of discouraging price-sensitive users, and thus a greater proportion of costs would need to be recouped from the remaining users in the future.

8.3.2 Views of interested parties on basis of charges (weight based charges)

MTOW-based charges

Cathay Pacific reiterated that en route charges should be determined by the cost of service and not capacity to pay. Cathay Pacific noted that:

> … service delivery is independent of productive capacity. Effort and resource expended on service delivery in the enroute environment is the same regardless of whether the customer is operating an A380 or a business jet.
>
> … two of the largest service providers in the world (U.S.A. & China) do not have a weight component in their overflight charges. Both of those providers recognise that the weight of the aircraft is immaterial in this service delivery line.

> … MTOW does not necessarily correlate to passenger numbers. Ultra-longhaul operations can see very heavy aircraft (e.g. B777-200LR; B777-300ER; A340-500) with comparatively low passenger numbers. In some cases a lighter aircraft can have more productive capacity than a heavier one. For example, an A330 is lighter than an A340 but carries more passengers.
>
> … assessing an aircraft's productive capacity is far from a straightforward proposition.[56]

Emirates noted its disappointment that MTOW would be retained, on the basis that MTOW has no bearing on the cost of service delivery. However, Emirates welcomed the recommendation in the ACCC's preliminary view that Airservices continue to engage with customers on this issue.[57]

Industry versus company-average MTOW

VAA restated its previous views that it strongly opposed the use of average airline MTOW and would want to reserve the right to review it during period of the agreement. VAA stated that:

> The average weight charging removes the ability of VAA to manage its fleet capabilities through differing MTOWs and removes any competitive advantage that may be achieved through more efficient fleet planning. Should average weights be desired by Airservices, they should only be implemented as a company average weight and not an industry average weight.[58]

VAA also noted an error in the Airservices' calculation of the industry average MTOW for the B737-700, which is higher than VAA's own fleet average, despite VAA being the only user of that aircraft.

MTOW cap versus less than proportional MTOW-based charging

Cathay Pacific reiterated its dissatisfaction with the 500 tonne weight cap. In particular, Cathay Pacific noted that:

> …a larger aircraft does not always mean a more efficient aircraft and an incentive to encourage more efficient aircraft therefore does not correlate to the imposition of a 500T cap.[59]

8.3.3 Airservices' response on basis of charges (weight based charges)

Airservices did not provide any additional comments in relation to the basis of charges.

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[56] Cathay Pacific Airways, *Submission in response to the ACCC's preliminary view*, 3 August 2011, pp. 1-2.

[57] Emirates, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 1.

[58] VAA, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 5.

[59] Cathay Pacific Airways, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

8.3.4 ACCC's final view on basis of charges (weight based charges)

MTOW-based charging

The ACCC notes submissions from stakeholders' that the cost of service delivery is independent of productive capacity in circumstances where MTOW does not correlate with passenger numbers.

The ACCC's preliminary view stated it is generally accepted that the value of services to the user is reflected in an aircraft's productive capacity — whether reflected in passenger numbers, freight on board, or length of the flight. As productive capacity is related to aircraft weight, aircraft weight is commonly used in air navigation charges to reflect value of service.[60]

More generally, the value of a service to the user (represented by aircraft weight) is reflected in the users' capacity (or willingness) to pay, which is important for determining efficient pricing.

The ACCC is aware that some airlines have a preference for, and there are advantages associated with, en route charges being determined by the cost of service provision. However, the ACCC reiterates its preliminary view that pricing mechanisms based only on distance or align charges more closely with costs have the potential to ignore users' capacity to pay and hence result in inefficient outcomes for Airservices and its users. These alternative mechanisms may also suffer from a significant level of administrative complexity.

The ACCC notes Cathay Pacific's submission that some ANSPs do not have a weight component in their overflight charges. However, the ACCC notes that aircraft weight is used by ANSPs in many countries, in combination with distance, as a basis for setting charges.[61] These include Canada, New Zealand and South Africa.

The use of aircraft weight as a basis of charging is also consistent with ICAO's *Policies on Charges for Airports and Air Navigation Services*,[62] which states that en route charges should be based on:

i) the distance flown within a defined area

ii) the aircraft weight.[63]

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60 NAVCanada, Service charges discussion paper, 2005, pp. 9-10. See also Kaplan, Daniel , Toward Rational Pricing of the US Airport and Airways System, Advances in Airline Economics, Vol 2 (2007) p.74.

61 For example, NAV Canada: enroute = R (unit rate) x W (weight factor = square root of MTOW) x D (distance); EuroControl: route charges = d (distance) x p (weight factor = square root of MTOW/50) x t (unit rate).

62 ICAO's Policies on Charges for Airports and Air Navigation Services, Eighth edition – 2009, Doc 9082, accessed at http://www.icao.int/icaonet/dcs/9082/9082_8ed_en.pdf.

63 International Civil Aviation Organisation, *ICAO's Policies on Charges for Airports and Air Navigation Services*, 2009, p. 18.

ICAO also recognises that the characteristics of a given airspace will determine the most appropriate charging method for that airspace.[64] As noted in the ACCC's preliminary view, Airservices has explored various pricing options with users, such as through Airservices' price structure consultation process in 2008, and has superior information to the ACCC to be able to determine price structures that best recover costs and maximise network usage.

The ACCC encourages Airservices to continue to consult with users in relation to pricing mechanisms to ensure the bases of charges remain appropriate, and consistent with efficient pricing principles.

Industry versus company-average MTOW

The ACCC reiterates its preliminary view that the use of an industry average MTOW is reasonable.

The ACCC notes Virgin's concern that the average MTOW for the B737-700 is listed by Airservices as 70 tonnes, which is greater than Virgin's fleet average MTOW (66.3 tonnes), despite Virgin being the only operator of that aircraft.

The ACCC considers that Airservices should consult with users to ensure that the industry average it adopts is accurate and appropriate to current industry circumstances.

MTOW cap versus less than proportional MTOW-based charging

The ACCC notes Cathay Pacific's submission in relation to the lack of correlation between aircraft weight, efficiency and the imposition of a weight cap. The ACCC is also mindful of ICAO's recommendation that weight should be taken into account 'less than proportionately'.

The ACCC repeats its preliminary view that it acknowledges that Airservices' proposed cap appears to be a step in the right direction to ensure consistency with ICAO's recommendation. The ACCC remains of the view that Airservices' 500 tonne cap is reasonable for the reasons outlined in its preliminary view, and notes that Airservices should continue to review the weight cap to ensure that it remains appropriate.

8.4 Other basis of charges issues

8.4.1 ACCC's preliminary view on other basis of charges issues

The ACCC considered a number of other basis of charges issues proposed in Airservices' draft price notification. These were:

- options for splitting en route charges into functional services lines, or by oceanic and continental airspace
- charges for non-aviation call outs

[64] Ibid, p. 19.

- a charge-free threshold for GA users

8.4.2 Views of interested parties on other basis of charges issues

Gold Coast Airport stated that it:

> rejects outright the charges for non-airside call-outs on the basis that we are currently over serviced. Should the services be required a negotiated outcome is required on a location by location basis. This non regulated service can be provided by alternative suppliers.[65]

8.4.3 Airservices' response on other basis of charges issues

Airservices did not provide any comment on the other basis of charges issues.

8.4.4 ACCC's final view on other basis of charges issues

The ACCC's views remain unchanged in relation to the issues outlined above.

The ACCC reiterates its preliminary view that the proposed non-aviation call out charges were generally supported in the first round of submissions. The ACCC does not consider the proposed charges to be unreasonable.

8.5 Timing of recovery of capital costs

8.5.1 ACCC's preliminary view on timing of recovery of capital costs

In its preliminary view the ACCC focused on the prudency of the method of funding, and whether the amounts that are recovered from users by Airservices do not exceed the costs.

The ACCC accepted that the period between the beginning of funding and the commissioning of assets in this case was not unreasonable given the nature of the industry. The ACCC further considered that the level of prefunding embodied in the draft price notification did not result in a significant increase in Airservices' cost recovery in that period.

The ACCC encouraged Airservices to consider the costs and benefits of alternative methods of funding in terms of overall costs, and impact on prices over time, to ensure that the most prudent method of funding capital projects is implemented.

8.5.2 Views of interested parties on timing of recovery of capital costs

Qantas reiterated its view that prefunding of assets was inequitable and unacceptable. It stated that Qantas and its passengers pay for assets that they cannot currently use, and in most cases do not benefit for an uncertain period. Qantas stated that other stakeholders may avoid pre-funding costs by entering an agreement after the commissioning of the assets.

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65 Gold Coast Airport, *Submission in response to the ACCC's preliminary view*, 3 August 2011, p. 2.

Qantas further argued that the cost of prefunding was compounded with the application of a WACC to the asset costs, and recovering those costs during the period prior to the use of the assets. Qantas argued that it was appropriate to commence applying a charge on assets only at the time of commissioning those assets.

Qantas called for the removal of all prefunding costs, specifically the ATM Future Systems project, which it believed should be negotiated outside the current LTPA, until more detail can be provided.

8.5.3 Airservices' response on timing of recovery of capital costs

Airservices did not provide any comments on the ACCC's preliminary view on timing of recovery of capital costs.

8.5.4 ACCC's final view on timing of recovery of capital costs

In its preliminary view, the ACCC noted that its focus in relation to the timing of recovery of capital project costs was on the prudency of the method of funding, and whether the amounts that are recovered from users by Airservices do not exceed the costs. In addition, the ACCC encouraged Airservices to consider the costs and benefits of alternative methods of funding, also taking into account impact on prices over time.

The ACCC acknowledges that inequity over time may be a concern for stakeholders in relation to prefunding, or indeed any method of funding capital projects, depending on the expected life of infrastructure and movement of firms into and out of the industry.

The ACCC reiterates its view that the time to commissioning of assets (18 months) is not an unreasonable period of prefunding, given the nature of the industry.

The ACCC further notes that the International Civil Aviation Organisation (ICAO) *Policies on Charges for Airports and Air Navigation Services* contemplates prefunding:

> 32. The Council considers, notwithstanding the principles of cost-relatedness for charges and of the protection of users from being charged for facilities that do not exist or are not provided (currently or in the future) that, after having allowed for possible contributions from non-aeronautical revenues, pre-funding of projects may be accepted in specific circumstances where this is the most appropriate means of financing long-term, large-scale investment, provided that strict safeguards are in place, including the following:
>
> > 1. Effective and transparent economic oversight of user charges and the related provision of services, including performance auditing and 'benchmarking' (comparison of productivity criteria against other similar enterprises);
> >
> > 2. Comprehensive and transparent accounting, with assurances that all aviation user charges are, and will remain, earmarked for civil aviation services or projects;
> >
> > 3. Advance, transparent and substantive consultation by airports and, to the greatest extent possible, agreement with users regarding significant projects; and

> 4. Application for a limited period of time with users benefiting from lower charges and from smoother transition in changes to charges than would otherwise have been the case once new facilities or infrastructure are in place.[66]

The ACCC considers that it is reasonable to expect that Airservices acts consistently with the ICAO principles above. The ACCC encourages Airservices to make explicit provision for the PCC to perform a role in holding Airservices accountable in this respect. This will involve Airservices providing adequate information and opportunity for consultation, such that stakeholders can ascertain Airservices' adherence to the principles. Airservices should also be able to demonstrate to stakeholders through this process that it will not set out to recover more than its expected costs (including the cost of capital) as a result of prefunding (discussed in more detail below). Airservices' commitment to reporting on capital expenditure on a project-by-project basis for projects greater than $10 million, together with the associated risk-sharing arrangements, will support this process.

The ACCC also has a role through the price notification process, in its assessment of the level of user charges, and the governance arrangements that support efficiency of expenditure, including capital expenditure. As noted above, the ACCC considers that Airservices' implementation of governance arrangements supporting the prudency of capital expenditure will be relevant to whether a short-form assessment process is appropriate to Airservices' annual locality notices.

As noted in its preliminary view, the ACCC is further satisfied, based on information provided by Airservices confidentially, that the level of prefunding in the draft price notification did not result in a significant increase in Airservices' cost recovery over the period.

9 The ACCC's final decision

The ACCC's decision, for the reasons set out in this decision paper, is to **object** to Airservices' proposed price increases for terminal navigation and aviation rescue and fire-fighting services. This decision is made pursuant to section 95Z of the CCA.

[66] International Civil Aviation Organisation, *Policies on Charges for Airports and Air Navigation Services*, Eighth edition – 2009, Doc 9082, www.icao.int, p. 10.

Appendix A: Airservices Australia's current and proposed prices and price structure

A.1 En route services

Charging formula for en route services:

- For IFR aircraft with an MTOW of 20 tonnes or more:

$$price \times \frac{distance}{100} \times \sqrt{MTOW}$$

- For IFR aircraft with an MTOW up to 20 tonnes:

$$price \times \frac{distance}{100} \times MTOW$$

Table A1: Airservices' current and proposed prices for en route services

Current price	En route service	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
$4.18	20 tonnes or more	$4.14	$4.12	$4.10	$4.09	$4.08
$0.93	Up to 20 tonnes	$0.93	$0.92	$0.92	$0.91	$0.91

A.2 TN services

Charging formula for TN services:

- For all aircraft:

$$price_{location} \times MTOW$$

Note: MTOW shall not exceed 500 tonnes.

Table A2: Airservices' current and proposed prices for TN services

Current price	TN service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
$11.43	Adelaide	$11.66	$11.83	$11.89	$11.95	$12.01
$5.83	Brisbane	$6.12	$6.18	$6.21	$6.21	$6.21
$10.95	Cairns	$11.50	$11.90	$12.32	$12.32	$12.32
$12.66	Canberra	$12.28	$12.03	$11.91	$11.80	$11.68
$10.82	Coolangatta (Gold Coast)	$10.28	$9.77	$9.28	$8.81	$8.50

Current price	TN service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
$5.06	Melbourne	$5.31	$5.50	$5.51	$5.53	$5.54
$8.63	Perth	$8.20	$8.03	$7.87	$7.72	$7.56
$5.57	Sydney	$5.58	$5.59	$5.60	$5.61	$5.62
$12.69	Albury	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Alice springs	$13.32	$13.79	$14.27	$14.77	$15.29
$4.70	Avalon	$4.70	$4.86	$5.03	$5.21	$5.39
-	Broome	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Coffs Harbour	$13.32	$13.79	$14.27	$14.77	$15.29
$9.20	Hamilton Island	$9.66	$10.00	$10.35	$10.71	$11.09
$9.54	Hobart	$9.64	$9.73	$9.78	$9.78	$9.78
-	Karratha	$13.32	$13.79	$14.27	$14.77	$14.92
$12.22	Launceston	$12.83	$13.28	$13.74	$14.23	$14.72
$12.69	Mackay	$12.44	$12.31	$12.19	$12.07	$11.95
$12.69	Maroochydore (Sunshine Coast)	$13.32	$13.79	$14.14	$14.28	$14.28
$12.69	Rockhampton	$12.94	$13.20	$13.33	$13.47	$13.47
$12.69	Tamworth	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Archerfield	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Bankstown	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Camden	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Essendon	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Jandakot	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Moorabbin	$13.32	$13.79	$14.27	$14.77	$15.29
$12.69	Parafield	$13.32	$13.79	$14.27	$14.77	$15.29
$2.26	Darwin	$2.15	$2.04	$1.94	$1.84	$1.75
$2.94	Townsville	$2.79	$2.65	$2.52	$2.39	$2.27

A.3 ARFF services

Charging formula for ARFF services:

- For all aircraft greater than 15.1 tonnes and target aircraft between 5.7 and 15.1 tonnes:

  $$price_{category,location} \times MTOW$$

  Note: MTWO shall not exceed 500 tonnes.

Table A3: Airservices' current and proposed prices for ARFF services

Current price	ARFF service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
Category 6 aircraft and below						
$1.81	Brisbane	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Melbourne	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Sydney	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Perth	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Adelaide	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Cairns	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Darwin	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Gold Coast	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Canberra	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Hobart	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Karratha	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Townsville	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Alice Springs	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Avalon	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Ayres Rock	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Broome	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Hamilton Island	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Launceston	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Mackay	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Rockhampton	$1.99	$2.14	$2.25	$2.29	$2.32
$1.81	Sunshine Coast	$1.99	$2.14	$2.25	$2.29	$2.32
Category 7 aircraft						
$1.93	Brisbane	$2.12	$2.34	$2.45	$2.57	$2.57
$1.89	Melbourne	$2.08	$2.29	$2.40	$2.52	$2.52
$1.86	Sydney	$2.05	$2.25	$2.36	$2.48	$2.48
$2.01	Perth	$2.21	$2.43	$2.61	$2.75	$2.81
$2.33	Adelaide	$2.56	$2.82	$2.96	$3.11	$3.26
$2.29	Cairns	$2.52	$2.77	$3.05	$3.35	$3.69
$4.01	Coolangatta	$3.97	$3.93	$3.89	$3.85	$3.79
$3.39	Darwin	$3.73	$4.10	$4.51	$4.96	$5.46
$7.91	Canberra	$8.31	$8.51	$8.73	$8.94	$9.08
$6.73	Hobart	$7.40	$8.14	$8.96	$9.85	$10.00

Current price	ARFF service location	Proposed price (incl. GST)				
		2011-12	2012-13	2013-14	2014-15	2015-16
$7.40	Karratha	$7.77	$7.96	$8.16	$8.37	$8.37
$8.47	Townsville	$9.32	$10.25	$11.27	$12.40	$13.64
Category 8 aircraft						
$2.62	Brisbane	$2.88	$3.17	$3.33	$3.41	$3.41
$2.29	Melbourne	$2.52	$2.77	$2.91	$2.98	$3.01
$2.08	Sydney	$2.29	$2.52	$2.64	$2.64	$2.64
$3.01	Perth	$3.31	$3.64	$4.01	$4.41	$4.85
$9.12	Adelaide	$8.12	$7.22	$6.50	$5.85	$5.27
$4.76	Cairns	$5.24	$5.76	$6.34	$6.97	$7.67
$4.01	Coolangatta	$4.41	$4.85	$5.34	$5.87	$6.46
$16.06	Darwin	$17.67	$19.43	$20.40	$21.42	$21.75
Category 9 and 10 aircraft						
$3.70	Brisbane	$4.16	$4.58	$5.04	$5.54	$6.09
$3.03	Melbourne	$3.41	$3.75	$4.12	$4.54	$4.99
$2.45	Sydney	$2.76	$3.03	$3.34	$3.67	$3.67
$5.08	Perth	$5.72	$6.29	$6.92	$7.61	$8.37

Appendix B: List of submissions

The ACCC received submissions on its preliminary view from the following parties:

- Adelaide Airport
- Air New Zealand
- Board of Airline Representatives of Australia (BARA)
- Cathay Pacific Airways
- Emirates
- Gold Coast Airport
- International Air Transport Association (IATA)
- Qantas Group (comprised of Qantas, Jetstar and QantasLink)
- Regional Aviation Association of Australia (RAAA)
- Regional Express (REX)
- Virgin Australia Group of Airlines (VAA)

The submissions are available on the ACCC's website at www.accc.gov.au/aviation.[67]

[67] www.accc.gov.au/aviation > Airservices Australia > Price notifications > Long-term price notification 2011 > ACCC preliminary view and submissions received.

Appendix C: About Airservices Australia

Airservices was established under the *Air Services Act 1995* (AS Act). It is a monopoly provider of air traffic management and aviation rescue and fire fighting services.

In performing its functions, Airservices is required by section 9 of the AS Act to regard the safety of air navigation as its most important consideration. Under section 10, Airservices is, where appropriate, required to consult with government, commercial, industrial, consumer and other relevant bodies and organisations (including the International Civil Aviation Organization (ICAO) and bodies representing the aviation industry).

C.1 Ministerial role in price setting

Under section 53 of the AS Act, the Board of Airservices may set charges for services and facilities. Under section 54, however, the Board must provide the Minister with written notice of the proposed determination and the Minister may approve or disapprove the proposed determination.

C.2 Corporate plan

In preparing a corporate plan, Airservices is required under section 13 of the AS Act to consider eight matters including:

- the need for high standards of aviation safety
- the known objectives and policies of the Commonwealth Government
- any directions made by the Minister under section 16
- any payments made by the Commonwealth to Airservices to fund its search and rescue services
- the need to maintain a reasonable level of reserves with consideration to future infrastructure requirements
- the need to earn a reasonable rate of return on assets (other than assets wholly or principally used in search and rescue services)
- the expectation of the government that Airservices will pay a reasonable dividend
- any other commercial considerations that may be appropriate.

Under section 14 the Minister may direct changes to the corporate plan regarding financial targets and performance indicators.

C.3 Minister's directions

Under section 16 of the AS Act, the Minister may give written directions to Airservices about the performance of its functions. Particulars of any directions are to be included in Airservices' annual report.

If Airservices satisfies the minister under subsection 16(4) of the AS Act that it will incur financial detriment by complying with a direction, the government may provide reimbursement. Financial detriment is taken to include incurring costs that are greater than would otherwise have been incurred and forgoing revenue that would otherwise have been received.

C.4 CASA's role in determining services to be provided

The Civil Aviation Safety Authority (CASA), responsible to the Minister for Infrastructure and Transport, is the regulatory agency responsible for safety. In particular, CASA is responsible for matters such as the classification of airspace and the designation of air routes.

CASA regulations require that services are provided when passenger or aircraft movements exceed certain thresholds.

Appendix D: The ACCC's role in the regulation of Airservices Australia

The provision of TN, en route and ARFF services by Airservices are declared to be notified services under section 95X of the *Competition and Consumer Act 2010* (CCA).[68] The relevant declaration, Declaration no. 66, is available on the ACCC's website at: www.accc.gov.au/aviation.[69]

D.1 The ACCC is responsible for assessing Airservices Australia's price notifications

A declared firm cannot raise the price of declared services beyond its peak price of the previous 12 months unless it first notifies the ACCC of a proposed price increase and the terms and conditions of supply. Following the lodgement of the price notification, there is a price-freeze period of 21 days. The ACCC is then responsible for assessing the proposed price increase.

The price-freeze period ceases when:

- the ACCC advises it does not object to the proposed price increase
- the declared firm agrees to implement a lower price specified by the ACCC[70]
- the prescribed period – initially 21 days – expires[71].

The ACCC has the option of recommending an inquiry to the minister if the outcome of the procedure is perceived to be unsatisfactory.

As set out in section 95ZB of the CCA, there is an 'applicable period' of initially 21 days within which the ACCC is to make its assessment, starting on the day on which the formal price notification is lodged.

However, price notifications are often complex. Therefore, the ACCC suggests that a declared firm submit a draft price notification for consideration prior to lodgement of a formal price notification. This provides the declared firm and the ACCC with sufficient

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68 The declaration originally had effect under section 21 of the *Prices Surveillance Act 1983* (PS Act). On 1 March 2004, the PS Act was repealed and the declaration was taken to have effect under Part VIIA of the *Trade Practices Act 1974* (TPA). On 1 January 2011, the TPA was renamed the *Competition and Consumer Act 2010*.

69 www.accc.gov.au/aviation > Airservices Australia > Declaration No. 66.

70 In circumstances where the ACCC has given a response notice under subsection 95Z(6)(c) of the CCA the price- freeze period is extended by 14 days.

71 Pursuant to subsection 95ZB(2) of the CCA the ACCC may specify a longer price-freeze period with the consent of the person who gave the locality notice. In circumstances where the ACCC has given a response notice under subsection 95Z(6)(c) the period is also extended by 14 days.

opportunity to consult with each other (and other parties where appropriate) to consider all relevant issues involved in the price proposal, and to ensure that all information requirements supporting the proposal are satisfied.

Although a declared firm is only required under Part VIIA of the CCA to submit a proposed price in its price notifications, the ACCC has encouraged Airservices to also include future price paths (see section 6.1), which it considers to be relevant in its assessment of the price notification against the relevant criteria in the CCA (see section 3.2).

Where a declared firm first submits a price notification that includes a long-term price path, the ACCC will conduct a detailed assessment of the substance of the proposed prices over the full period covered by the price path. The ACCC will then make a decision on the proposed prices covering the first year of the period. The declared firm will be required to submit locality notices for each of the subsequent years covered by the price path. For those subsequent years, the ACCC may consider it appropriate to conduct a short-form assessment process.

A detailed outline of the ACCC's suggested process for all price notifications, including a discussion of short-form assessments, is contained in the ACCC's *Statement of regulatory approach to assessing price notifications* (June 2009), which is available on the ACCC's website at: www.accc.gov.au.[72]

D.2 The statutory criteria for assessing price notifications

In exercising its powers and performing its functions, subsection 95G(7) of the CCA requires the ACCC to have particular regard to the need to:

d) maintain investment and employment, including the influence of profitability on investment and employment

e) discourage a person who is in a position to substantially influence a market for goods or services from taking advantage of that power in setting prices

f) discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

In assessing the price notification against the statutory criteria, the ACCC has interpreted the criteria in subsections 95G(7)(a) and (b) as seeking to promote economically efficient investment and employment throughout the economy. This is broadly consistent with the objectives outlined by the Government for pricing infrastructure services under the national access regime.

Economic efficiency encompasses the following elements:

[72] www.accc.gov.au > For regulated industries > Multi-industry documents and submissions > Regulatory approach to price notifications.

- productive efficiency, which is achieved when firms have the appropriate incentives to produce goods or services at least cost, and production activities are distributed between firms in a manner that minimises industry-wide costs.

- allocative efficiency, which is achieved when firms employ resources to produce goods and services that provide the maximum benefit to society.

- dynamic efficiency, which is achieved when firms have appropriate incentives to invest, innovate and improve the range and quality of goods and services, increase productivity and reduce costs over time.

In an open and competitive economy, efficient provision of services underpins investment and employment opportunities. Welfare enhancing investment and employment in the national economy will be promoted when firms produce goods or services at least cost and charge prices that correspond as closely as possible to competitive levels. Although a competitive benchmark may be lacking in industries subject to prices surveillance, economically efficient prices would, as in competitive areas, reflect least-cost production and include profit margins reflecting a return on capital commensurate with the risks faced by the firm.

Prices above efficient levels result in a loss of allocative efficiency as they discourage some marginal purchases which would have had a value to the purchaser above the cost of supply. As excessive prices are passed on in higher costs for other industries using the services, they lead to lower profits and potentially a loss of investment and employment opportunity in the competitive sectors of the economy.

Accordingly, the ACCC considers that the criteria in subsections 95G(7) will generally be met by economically efficient prices which reflect:

- an efficient cost base

- a reasonable rate of return on capital.

Including a reasonable rate of return on capital addresses the criterion in paragraph 95G(7)(a) by providing incentives to maintain profitable investment. At the same time, discouraging a declared firm from charging prices based on profits greater than the reasonable rate of return, as per criterion in paragraph 95G(7)(b), addresses issues relating to market power that the firm may have in the market for notified goods and services.

With regard to the criterion in paragraph 95G(7)(c), in assessing a price notification the ACCC will usually treat the level of wages and conditions as part of its broader concern for an efficient cost base.

As discussed in section 6 of this document, there are also a range of non-commercial incentives that influence Airservices' incentives and behaviour, and these will be taken into account in assessing the price notification where applicable.

More detailed information on the ACCC's approach to the interpretation of the statutory criteria is contained in the ACCC's *Statement of regulatory approach to assessing price notifications* (June 2009), which is available on the ACCC's website.

Appendix E: The ACCC's approach to assessing Airservices' pricing and structure of prices

The purpose of prices surveillance is to achieve efficient prices and protect consumers in markets where competitive pressures are not sufficient to do so. Efficient pricing is concerned with both the level of prices, and the way in which prices are structured in order to recover revenue from different user groups

In the first instance, the ACCC undertakes an assessment of whether the proposed price increases are reasonable given the business's revenue requirements. This provides a check on whether the business is generating monopoly profits, and is done through the building-block model. It is concerned principally with the *overall level* of prices. The ACCC is also interested in the efficiency of the business's cost base, as this will affect the level of prices and magnitude of any price increases.

In assessing the structure of prices, the ACCC will generally be interested in whether there has been or is likely to be an adverse impact on the efficiency of resource allocation decisions by the business and its customers. That is, whether the prices of service lines or prices at certain locations are likely to distort demand for the services.

Principles for efficient pricing

In a general sense the ACCC is reluctant to prescribe individual charges at too fine a level of detail. While monopoly service provision may raise concerns about the level of prices, it is generally considered that businesses possess greater motivation and information than third party arbiters to find price structures that best recover costs and maximise network usage. For example, it is not feasible or desirable to simply increase each price by a proportion to reflect increases in total costs. This approach would be insufficiently subtle to accommodate the commercial judgments which must take place at a micro level, in particular the sensitivity of different users to price changes (price elasticity of demand).

Nevertheless, there are some tests of costs that the ACCC may conduct to gain a level of comfort with the efficiency of proposed prices.[73] Generally, setting prices of a service below incremental cost may encourage inefficient over-use of that service, while setting prices above stand alone cost could provide Airservices with monopoly returns.[74]

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[73] See ACCC, Preliminary View: Airservices Australia Draft price notification, November 2004, section 9.

[74] In adopting Faulhaber's approach to testing for cross- subsidies in prices of a regulated multi-product firm, the ACCC noted that the stand-alone cost of providing a service, where a firm provides multiple services, is the cost of providing only that particular service. The incremental cost of providing a particular service is the additional cost that the firm incurs as a result of providing that service in addition to its other services. (ACCC, *Preliminary View: Airservices Australia Draft Price Notification*, November 2004, p. 90).

When considering individual charges, it is relevant to consider the likely effect on demand of any increase in price. Inverse elasticity pricing involves levying higher charges for those products for which demand is least responsive to changes in these charges. This leads to the recovery of costs in a manner which minimises the loss of transactions.[75]

Qualifications and constraints

The ACCC is required to examine Airservices draft price notification taking the policy parameters in which it operates as given. Airservices is a government owned entity that provides services as required by the aviation safety regulator, CASA. Under section 46 of the Airservices Act, Airservices is required to operate as a commercial entity, with the expectation that it will provide an annual dividend to the Government. Implicit in this is a requirement to recover costs of the entire business, that is, that the Government does not have a policy that any use of the services will be taxpayer funded. Further, Airservices is required to provide services at any location if directed to by CASA.

Airservices has adopted a hybrid approach to pricing, which involves a mix of network pricing and location specific pricing. As a result, some services, or services in some locations over-recover their costs, and other services and locations under-recover. In some cases, prices do not recover incremental costs of providing the service.

Airservices' requirement to recover costs across entire business

In assessing Airservices' proposed structure of pricing, the ACCC must consider Airservices' requirement to raise sufficient revenue to recover its costs across the regulated services.

In 2004-05 the ACCC outlined its pricing principles for efficient pricing and allocation of fixed and common costs. Its subsequent analysis highlighted areas where it considered cross-subsidies existed, as some services did not recover even incremental costs. The ACCC did not consider cross-subsidisation to be a concern from an efficiency perspective in itself, and identified the circumstances under which it would be a concern as:

- if competition were to be introduced for the provision of certain services provided by Airservices, as the cross-subsidy could lead to inefficient entry, or
- if the level of cross subsidy was such that regional and GA airports were being kept open when the value of these airports to their users is less than the costs of these airports.[76]

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[75] The inverse elasticity method of cost allocation involves allocating common costs between users with the objective of maximising efficiency. In circumstances where demand for services produced by a multi-product monopolist are independent (i.e. where the cross-price elasticities of demand are zero), allocating common costs in inverse proportion to various users' price elasticities of demand will maximise economic welfare.

[76] ACCC, Preliminary view: Airservices Australia Draft Price Notification, November 2004, p. 96.

The ACCC further considered that economically efficient prices for services may involve some services being priced below incremental cost if relatively higher prices would lead to inefficient substitution to other, less preferred services.

It is important to note that, in respect of ARFF, the ACCC remains of the view, as it stated in its 2005 decision, that it appears unlikely that the market for ARFF services will be opened up to competition in during the period covered by this price notification. Given this, the proposed pricing structure (that is, basis of charges across en route and TN and ARFF) would not distort entry decisions.

The second scenario that the ACCC identified as a potential concern was where services were priced below incremental cost (at regional and GA locations) such that airports remain open when their value to users is less than the cost of the airport. In its 2004 preliminary view, the ACCC stated that it had not been provided with any evidence of this. In order to make an assessment of structure of prices in this context, the necessary information regarding price elasticities of various user groups at each location, including any cross elasticities or complements, has not been available. That said, from observation of past and present activity, it would appear that demand at major airports is relatively insensitive to price, when compared to regional and smaller airports.[77]

Equity considerations

Inverse elasticity pricing can be at odds with concepts of fairness and equity across user groups in the sense that charges for some services, or in some locations, may not be limited to the cost of providing the service that they use. Prices for other services, or services provided in some locations, may be lower than the full cost of providing them. Some groups may be concerned that they are effectively subsidising other businesses using those services.

As an economic regulator, the ACCC's role in assessing price structure proposed by a declared firm under Part VIIA of the CCA focuses on those situations where there is evidence that a proposed pricing structure issue is likely to create distortions in demand or where there are clear opportunities for more equitable outcomes through pricing without creating such distortions.

Inverse elasticity pricing attempts to approximate the relative value of a service to different users, as is reflected in their willingness or capacity to pay. This is consistent with economic efficiency principles because users are paying according to the value they attribute to the product or service. Indeed inverse elasticity pricing enables the reduction of deadweight losses that are brought about by loss of economic activity as a result of prices being high such that some users leave the market.

The ACCC assesses the level of prices Airservices charges its customers in the context of its demonstrated revenue requirements, the efficiency of its cost base, and efficiency of pricing. Further, the ACCC is required to make its assessment within the existing

[77] Productivity Commission, *Price Regulation of Airport Services: Inquiry Report*, January 2002, p. x. and Airservices Australia, *Draft price notification*, March 2011, p. 55.

policy framework. Broader questions relating to policy (for, example, how any shortfalls should be funded) are outside the scope of the ACCC's assessment of locality notices under Part VIIA. These issues are most appropriately addressed by the Government.