



Decision

Airservices Australia

Proposed Price Increase

Date: June 2003

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Executive Summary

On 1 April 2003, the Australian Competition and Consumer Commission (the Commission) received a draft price notification from Airservices Australia (Airservices).

On 19 June 2003, the Commission received a formal price notification of a proposed increase in price pursuant to the PS Act. The formal notification proposed the same prices that were contained in the draft notification.

Airservices is proposing a 6.95% increase to uncapped Terminal Navigation (TN) and Aviation Rescue and Fire-fighting (ARFF) ports, with a small number of exceptions, from 1 July 2003. In its formal price notification Airservices does not propose to increase the price of en-route Navigation (EN). The increases are proposed as temporary, applying for a 12-month period until 30 June 2004. Airservices has argued, though, that if this proposal is considered by the Commission to be unacceptable, then, in the alternative, it should allow maintenance of TN and ARFF prices at current levels and the temporary restoration of its en route prices back to July 2002 levels.

In revenue terms, the increased prices covered by the formal price notification would be expected to add around \$16m to Airservices' revenue in 2003/04. Of this total, \$11m comes from TN services and \$5 from ARFF services.¹

Air traffic control and ARFF services are declared pursuant to section 21 of the *Prices Surveillance Act 1983* (PS Act). Pursuant to section 22 of the PS Act, Airservices is required to notify the Commission of proposed increases to the prices of these services. The Commission may respond to the notification by either not objecting to the proposed prices, or not objecting to increases lower than the proposed prices (including no increase).

After receiving Airservices' draft notification the Commission released an Issues Paper in early April, calling for submissions. Submissions were received from airlines, airports and government, all of which opposed the proposed increases.

Following consideration of the issues raised in submissions the Commission released a Preliminary View on Airservices' draft notification in late May. The Commission's preliminary view was to object to the proposed price increases.

This document represents the Commission's final decision on Airservices' price notification. The Commission's final decision confirms its preliminary view which is to object to the proposed price increases.

¹ These revenue figures are based on *current* prices, and the volume projections provided by Airservices.

The main reason for the Commission's objection is that Airservices has failed to address the Commission's previously expressed preference for a longer-term approach to pricing. Instead, Airservices is seeking temporary price increases on the basis of short-term cost and activity forecasts.

Prices which, in the short run, increase in response to falling demand appears to be a consequence of a firm having substantial market power. In this respect, the Commission has concerns that Airservices' approach is inconsistent with the criteria set out in s 17(3)(b) of the PS Act, which the Commission must consider in reaching its decision.

On the other hand, longer term pricing promotes productive efficiency by encouraging Airservices to provide services at the lowest possible cost. Similarly, dynamic efficiency is enhanced as pricing cannot be simply adjusted to provide returns on investments the year after they are made. Rather, by sharing with users the risks associated with changes in demand, Airservices should face better incentives to time investments efficiently.

Prices that take into account changes over a reasonable future period also promote allocative efficiency as users face prices that are less likely to reflect excessive costs. This contributes towards efficient investment and employment in these markets, and thus promotes the criteria of s 17(3)(a) of the PS Act.

Furthermore, the pricing proposal put forward by Airservices does not address issues previously identified by the Commission, on related matters such as operating efficiency incentives and asset valuation. As such, Airservices has not made a strong case for price increases, particularly at a time in which the aviation industry as a whole is under significant duress.

In such circumstances, the Commission considers it should object to Airservices' proposal as it currently stands. Were it to act otherwise, there would be little incentive for Airservices to resolve the issues identified. Most particularly, there would be little incentive for Airservices to work with its customers towards agreeing upon a longer-term pricing model.

The Commission acknowledges that Airservices has taken steps to address issues previously identified in relation to CSOs and pricing services on the basis of their separable costs. Furthermore, the Commission notes that there may currently be some cross-subsidisation of the costs of terminal navigation and ARFF services by charges for en-route services. Nonetheless, these factors do not outweigh the Commission's other concerns.

Part A: Introduction

On 1 April 2003, the Commission received a Preliminary Pricing Proposal (draft price notification) from Airservices Australia (Airservices), proposing changes to the pricing of certain services, in accordance with the *Prices Surveillance Act 1983* (PS Act).

On 19 June 2003, the Commission received a formal price notification of a proposed increase in price pursuant to the PS Act. The formal notification proposed the same prices that were contained in the draft notification.

Airservices is proposing a 6.95% increase to uncapped Terminal Navigation (TN) and Aviation Rescue and Fire fighting (ARFF) ports, with a small number of exceptions, from 1 July 2003. Airservices does not propose to increase the price of en-route navigation services. Budgeted returns and the methodology used to calculate the returns are provided in the draft notification. The increases are proposed as temporary, applying for a 12-month period until 30 June 2004.

The Commission notes that the proposal is for price increases applied uniformly across most major airports². In its draft notification, Airservices also indicated the possibility of seeking further price increases later in the financial year.

The Commission last received a formal price notification from Airservices on 23 July 2002. In that case, the Commission did not object to a temporary weighted average increase of 5.1% across all services, including increases of 3.9% in en-route navigation for the 2002/03 financial year³.

In January 2003, Airservices reduced en-route charges back to their 30 June 2002 level. No changes were made to TN or ARFF prices at that time.

The current price notification proposes increases in ARFF and TN charges in addition to the average 5.9% increase in terminal navigation and average 8.1% increase in ARFF charges approved by the Commission in its decision last year.

1 Airservices Australia's Proposal

Airservices states that during 2002/03, activity growth has proved to be well below the forecast accepted by the Commission in its decision last year. Airservices current estimate is that activity growth for the year will be -0.1%, compared to its budget assumption of +2.9%. Airservices has attributed the reduction in growth levels mainly to the impact of the war in Iraq and the SARS virus.

² Terminal navigation charges at Adelaide, Brisbane, Cairns, Canberra, Coolangatta, Melbourne, Perth and Sydney airports are proposed to increase by 6.95%. Similarly, charges for aviation fire-fighting and rescue at these airports – as well as Darwin, Alice Springs, Hobart, and Launceston airports - are proposed to increase by 6.95%. Larger increases in terminal navigation charges at Hamilton Island, and aviation fire-fighting and rescue charges at Mackay and Rockhampton, are also proposed. Full details of the proposed prices are available in Airservices' submission, available on the ACCC website at www.accc.gov.au.

³ The Commission's decision is available at www.accc.gov.au/airport/airserv.html.

Airservices' financial plan for 2003/04 proposes a 2.7% weighted average increase to current prices. This planned increase was originally predicated on a 2.3% weighted average growth in activity for 2003/04. Airservices, has, however, recently reviewed its activity forecasts and advised the Commission that it is now only expecting a 1.1% weighted average growth in activity for 2003/04.

En route services are expected to maintain a reasonable rate of return at current prices and therefore are not included in this notification. The increase is proposed to be applied as a flat increase of 6.95% on current prices at uncapped TN and ARFF locations. The exceptions will be:

- Darwin and Townsville TN services, where the price to cover the use of facilities only will not change (Defence currently provides air traffic services at these airports);
- Hamilton Island, where the TN price will increase to the same level as other capped regional locations in order to minimise the losses incurred at this airport;
- ARFF services impacted by new CASA regulations, where prices will rise to recover the incremental recurring costs of upgraded services and an appropriate share of any start-up costs for new services.

Airservices requests that this increase be levied for a temporary period of 12 months from 1 July 2003. Furthermore, based on its Building Block calculations, Airservices claims that the revenues planned for 2003/04 will be around \$12 million below "allowable" revenues indicated by the model.

In addition, Airservices states that the proposed prices do not recover an \$11 million shortfall in the funding of the community service obligations at capped tower locations.

In Airservices' current notification, the asset and operating and maintenance related costs have been separated into regulated and unregulated service lines. However, Airservices suggests that more detailed allocations of asset values to specific services are not currently feasible.⁴

Airservices also states that the level of consultation and transparency over costs has increased, with capital expenditure plans for the next 5 years being shared with customers. Airservices indicates that this will be the start of an ongoing regular consultation process to link capital expenditure programs with customer expectations over pricing outcomes.

However, in response to the Commission's previous recommendation that a long-term pricing approach be adopted by Airservices, Airservices responds that the current volatile environment has made this "impractical and undesirable to adopt" at the present moment⁵.

⁴ Airservices Australia (1), *2003/04 Preliminary Pricing Proposal to the Australian Competition and Consumer Commission*, 31 March 2003, p11.

⁵ *ibid*, p8.

2 Legislative Framework

The provision of air traffic control services and airport rescue and fire fighting services is declared pursuant to section 21 of the PS Act. The relevant declaration, Declaration Number 66, is available from the Commission's website. Pursuant to section 22 of the PS Act, Airservices is required to notify the Commission of proposed increases in prices of the declared services. The Commission may respond to the notification by either not objecting to the proposed prices, or not objecting to increases lower than the proposed price increase (including no increase).

The statutory criteria for assessing a notification are set out in subsection 17(3) of the PS Act. This sub-section specifies that in assessing a notification, the Commission is required to have particular regard to:

- 17 (3) (a) the need to maintain investment and employment, including the influence of profitability on investment and employment;
- (b) the need to discourage a person who is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices; and
- (c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The Commission is of the view that, in relation to these first two criteria, an important consideration is that in an open and competitive market economy efficient provision of services underpins investment and employment opportunity. Investment and employment in the national economy will be promoted when firms produce goods or services efficiently and charge prices which correspond as closely as possible to competitive levels.

Monopoly suppliers do not necessarily produce goods or services at efficient cost levels or at competitive prices. If higher than efficient prices for intermediate services and products are passed on to the rest of the economy, there is a resultant loss in technical and allocative efficiency and potentially therefore in investment and employment opportunity.

The Commission considers that encouraging efficient pricing outcomes in line with more competitive conditions implies that price increases should stem from a cost base which is efficient and involves only appropriate margins.

Given this broad context, the Commission in assessing price notifications will direct its attention to:

- the efficiency of the cost base that the declared company is working from to earn a return; and
- the reasonableness of the rate of return that the declared company is seeking.

The third criterion outlined in paragraph 17(3)(c) no longer appears to be directly relevant to a prices notification because of changes to industrial relations legislation and wage determination practice. More details on these and other aspects of the Commission's approach to price notification is contained in its *Draft Statement of Regulatory Approach to Price Notifications* document, available on the website.

3 Process of assessment

The Commission received a draft notification from Airservices on 1 April 2003. The Commission released an Issues Paper on 10 April 2003, calling for submissions by close of business, 28 April 2003. A list of the submissions is set out in Appendix A.

The Commission released its Preliminary View of Airservices' draft notification on 23 May 2003, calling for comments by close of business, 6 June 2003. A list of the submissions received by the Commission in response to the Preliminary View is also detailed at Appendix A.

The Commission received a formal notification from Airservices on 19 June 2003. Under the PS Act, the Commission has 21 days from the receipt of a price notification to release a final decision.

4 About Airservices

Airservices is a statutory monopoly established under the *Air Services Act 1995* (AS Act) as a commercial authority responsible for a range of functions including the provision of safe and environmentally sound air traffic management and related services. It also has a responsibility under this Act to promote and foster aviation. Airservices operates 26 air traffic control towers, 15 fire stations and an extensive network of facilities through out the country, with approximately 2900 employees.

Airservices' en route air navigation services cover approximately 11% of the world's airspace including not only Australia's sovereign airspace, but also international airspace over the Pacific and Indian Oceans.

Airservices is a very significant organisation within the aviation industry in Australia, generating over \$500m in total annual revenue. By way of comparison, Airservices' charges are of more significance to airlines than fees and charges levied by all airports combined. In 2001/02 Airservices generated \$478m in airways revenue, compared to a total of \$412m in aeronautical revenue generated by airports formerly subject to price surveillance.

4.1 Legislative framework

This section outlines the main provisions of the AS Act and the *Commonwealth Authorities and Companies Act 1997* (CAC Act) under which Airservices currently operates.

4.1.1 Air Services Act 1995

The section below covers the key provisions of the AS Act which affect Airservices' operations and strategies.

(a) Airservices Australia's functions

Under section 8 of the AS Act, Airservices is responsible for:

- Providing facilities to permit safe navigation of aircraft within Australian administered airspace;
- Promoting and fostering civil aviation in Australia;
- Providing the following services for the purposes of giving effect to the Chicago Convention or for purposes relating to the safety, regularity or efficiency of air navigation:
 - Air traffic services;
 - Aeronautical information service;
 - Rescue and fire fighting service;
 - Aeronautical radio navigation service; and
 - An aeronautical telecommunications service.

- Co-operating with the Australian Transport Safety Bureau (ATSB) in relation to the investigation of aircraft accidents and incidents;
- Performing activities to protect the environment from the effects of, and effects associated with, the operation of Commonwealth jurisdiction aircraft;
- Performing functions prescribed by the regulations in relation to the effects of, and effects associated with, the operation of Commonwealth jurisdiction aircraft;
- Performing any functions conferred under the *Air Navigation Act 1922*;
- Performing any other functions prescribed by the regulations; and
- Providing consultancy and management services relating to any of the above matters.

Airservices may provide its services and facilities both within and outside Australian territory⁶.

In performing its functions, it is required under section 9 of the AS Act to regard the safety of air navigation as the most important consideration and under section 10 to consult with government, commercial, industrial, consumer and other relevant bodies. In 1998 the Government amended the AS Act to require Airservices to operate in a way that promotes the aviation industry.

(b) 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. Section 54(3) states that the Board may only

⁶ Airservices Australia (2), *Annual Report, 2000-2001*, pp1-2.

make its determination if it has been approved by the Minister or if the period by which the Minister must provide the Board a notice has expired.

(c) Corporate plan

In preparing a corporate plan under section 17 of the *Commonwealth Authorities and Companies Act 1997*, Airservices is required under section 13 of the AS Act to have regard to eight matters including:

- the need for aviation safety;
- the need to maintain a reasonable level of reserves having regard to future infrastructure requirements;
- the need to earn a reasonable rate of return on assets (other than assets wholly or principally used in the provision of search and rescue services); and
- the expectation of the Government that it will pay a reasonable dividend.

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

(d) Minister's directions under section 16 of AS Act

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

Under subsection 16(4) of the AS Act, if Airservices satisfies the Minister that it will incur financial detriment in 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 foregoing revenue that would otherwise have been received.

5 Airservices' Previous Notification

On 23 July 2002 Airservices provided the Commission with a notification proposing increases to the prices of enroute, TN and ARFF prices at a number of locations. The proposal was made as a consequence of the collapse of Ansett and in response to lower traffic volumes following the September 11, 2001 terrorist attacks. In that case, the Commission did not object to a temporary weighted increase of 5.1% across all services, including an average increase of 5.9% for TN, an average increase of 8.1% for ARFF and an increase of 3.9% in en route navigation for the 2002/03 financial year.

In January 2003, Airservices reduced en route charges back to their 30 June 2002 level. No changes were made to TN or ARFF prices at that time.

Part B: The Commission's Assessment

The building block methodology⁷ has been used by the Commission in past regulatory decisions, including the 2002 Airservices decision, to assess the revenue required for the provision of regulated services, giving consideration to the need for the declared company to earn a reasonable rate of return. Airservices has made use of the building block approach in its current pricing proposal.

Under this model required revenue is defined as the sum of projected efficient operating and maintenance costs, the return of capital and the return on capital. Utilising the required revenue and forecast activity, proposed price increases are then assessed.

The Commission in its 2002 decision raised a number of issues which it considers relevant to its current consideration of the Airservices preliminary price proposal. Specifically in its earlier decision the Commission was concerned that:

- it was unable to independently verify the efficiency of Airservices' cost base;
- it could not be assured that technical efficiency improvements had been exhausted or if such improvements would continue to be pursued;
- in the absence of sufficient information from Airservices, it was unable to determine the extent to which the recovery of costs for unfunded non-commercial activities (NCAs) and Community Service Obligations (CSOs) were appropriate; and
- Airservices had not, from the outset, provided sufficient information for the Commission to undertake a thorough review of asset values.

The Commission also recommended that in future pricing proposals, Airservices adopt a longer term view of price setting and allow for a thorough review of its cost structure. In addition, the Commission noted that in future it would prefer efficiency incentives built into Airservices' pricing structure, and that it preferred an economic rate of return to the accounting based measures of return used by Airservices.

In making its 2002 decision not to object to the temporary price increases sought by Airservices the Commission took into account that Airservices had passed on significant real price decreases to customers over the five year period commencing in 1997/98 and ending in 2001/02.

From the Commission's perspective the 2002 price notification represented the first time for several years that it had been involved in a significant Airservices price notification where price increases were sought. In particular, prior to the 2002 price notification process it had not formally identified to Airservices its concerns about the setting of prices based on short-term accounting rate of return targets.

In view of this the Commission in the 2002 decision provided clear direction to Airservices of the areas that it expected Airservices to address in any future price

⁷ The ACCC's approach to applying the building block approach is set out in the ACCC (1) *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999, and the (2) *Post-Tax Revenue Model*, October 2001.

notification. Many of the significant issues flagged in the 2002 decision, however, are not addressed in the current price proposal nor Airservices response to the Preliminary View.

As a consequence, Airservices is seeking approval for a price increase for a second successive year without major issues relevant to the Commission's deliberations being resolved. These issues are discussed in more detail in the following sections.

6 Long term pricing model

6.1 Introduction

As previously noted, the Commission considers the building block methodology provides an effective platform for Airservices to develop a long term pricing model. Such a model could incorporate an incentive mechanism such as a CPI-X price cap that could encourage and reward improvements in long-term cost efficiency, recognising the return on investment from improved productivity and innovation which drives down operating and maintenance costs. If these efficiencies are greater than the X factor then Airservices will retain the higher level of profits while sharing the benefits up to the X factor with its customers. Similarly, such an approach would reward Airservices for innovations that generate additional traffic volumes. Alternatively Airservices could be provided with similar efficiency incentives if its prices are retained at constant nominal levels for a certain defined period.

6.2 Airservices' initial position

Airservices' proposal is to increase temporarily some of its TN and ARFF prices for a 12 month period commencing from 1 July 2003.

Airservices argues that the aviation industry faces considerable uncertainty as to the shape of the environment in the short to medium term and that this makes long-term pricing impractical and undesirable. Consequently, only a one year pricing proposal has been adopted. Airservices has also indicated that if forecast activity levels are not realised then it may be left with no choice but to make a supplementary pricing submission, aimed at making up the shortfall in revenue through higher prices.

Airservices has recognised the Commission's previous recommendation for more stability in pricing but argues it is not appropriate to develop a medium term price path at the present time as the change in demand and the strategies required to meet that change cannot be reliably forecast.

Airservices does note, however, that close attention is being given to a discussion paper recently received from Qantas, and supported by BARA, which argues for a model broadly in keeping with the Commission's views on this issue.

6.3 Views of interested parties

BARA rejects the views articulated in Airservices' preliminary pricing notification that a longer-term approach is "unpractical and undesirable" and that its pricing approach is "in the best interests of customers". According to BARA what the global aviation industry requires more than anything at the moment is certainty. It further argues that the best way Airservices can contribute to that requirement and promote and foster civil aviation in Australia is to bring forward a pricing proposal that gives certainty about the level of services provided and the associated prices charged in the medium term.

BARA also argues that it is possible for Airservices to develop a long term pricing model in the current environment. In particular BARA notes that similar

organisations overseas, such as the National Air Traffic Service in the United Kingdom operate in the same environment as Airservices within the context of a longer term pricing model. In addition airlines and airports have recently negotiated a number of agreements covering price, service quality, investment, consultation and contractual terms which have a life of 5 years. Furthermore domestic carriers have entered into even longer long-term terminal access agreements in relation to a number of terminals previously controlled by Ansett. BARA therefore argues that it is possible to reach medium term agreements in the current environment.

BARA also argues that Airservices is different from airports in three relevant regards that should mean it is easier for Airservices to reach a medium term agreement with airlines:

- it has a superior credit rating (Airservices is rated AAA, the best rating held by an airport is Melbourne with A-) and a lower gearing ratio, indicating a greater capacity to bear financial risk;
- it has greater corporate resources than airports to develop such a proposal - it is notable that aeronautical revenue collected by Airservices from airlines exceeds the combined aeronautical revenue collected from airlines by all the major capital city and regional airports in Australia; and
- by its own admission it is less motivated by profit than privatised airports.

According to BARA these point to Airservices having a financial capacity to provide a long term pricing structure that is superior to that of airports. BARA therefore argues that either Airservices management is not able itself to develop such an agreement (raising questions about Airservices' efficiency) or that its shareholder is not prepared to accept the financial risks involved.

Qantas argues that the current volatile situation in the aviation industry is not a valid reason for Airservices inability to adopt a longer-term view of price setting. Nor is it a reason to disallow a thorough review of its cost base. At a minimum, Qantas believes that Airservices should have developed a financial (cost) model, based on current service requirements, for review by the Commission.

According to Qantas the current 'year on year' price setting approach by Airservices severely inhibits the ability of the Commission to adequately address its obligations under the *Prices Surveillance Act 1983* (PS Act), which in turn generates less efficient pricing outcomes. This situation occurs because the price-setting approach by Airservices does not allow for a number of key issues to be addressed, namely:

- justification of its operating costs for the current year, in this case 2003-04;
- identification of changes to costs attributable to regulatory changes;
- incorporation of anticipated savings from 'cost saving' capital expenditure; and
- robust establishment and tracking of asset values for pricing purposes.

Virgin Blue is also concerned that Airservices' focus on short terms events as the justification for TN and ARFF price increases places undue emphasis on short term fluctuations in aviation traffic and will undermine any incentive Airservices has to reduce costs and increase productivity over the medium to long term. Virgin Blue

argues that if Airservices were required to strive for greater efficiency and lower cost structures over the long-term it would be better able to sustain sudden or short-term losses without the need to continually request price increases. Virgin Blue suggests that “prices, especially those charged by a monopolist, tend to be “sticky” in the sense that prices very rarely fall as far or as quickly as they are raised, even if the cause of the price increase disappears unexpectedly”⁸.

Virgin Blue also argues that Airservices’ unwillingness to rule out further requests for price increases in the future indicates that Airservices considers price increases to be the main method by which it will maintain profitability over the short to medium term. Virgin Blue is concerned that any failure by the Commission to oppose Airservices pricing proposal may give Airservices’ “management the impression or belief that any future short term decline in profitability can also be offset by further price rises at the expense of cost reductions and efficiency gains”⁹.

The Mackay Port Authority (MPA), which administers Mackay Airport, points out that when it was faced with similar problems to Airservices following the events of September 11 2001 and the collapse of Ansett and Flight West it adopted a different approach to pricing its services than Airservices. It also suggests that rather than taking a “no risk” approach to the current volatile situation in the aviation industry and simply raise the cost of its services, Airservices should share the risk with other industry partners and develop innovative ways to keep prices down. MPA notes that the approach it adopted was to closely examine its cost structure and make savings as well as encourage Virgin Blue and Qantas to increase services by offering incentives. As a consequence MPA argues it had to forgo and risk its return on investment for eighteen months and take a long term approach rather than just increase prices to restore profits. Furthermore MPA argues that “had MPA taken the Airservices approach airport charges would have increased, Virgin Blue would not have commenced operation and passenger numbers shrunk”¹⁰.

The Regional Aviation Association of Australia argues that at a time when the aviation industry is struggling to remain viable it is “incomprehensible that one sector of the aviation industry (Airservices) would seek to increase charges on the airline sector which is reducing services and retrenching staff in order to remain viable”. They also state that “it is unacceptable that a monopoly provider increases costs to ensure profitability, when the very reason for the downturn in its profitability is the downturn in profitability of the industry it services”¹¹.

IATA supports a longer term view of price setting that will take in to account traffic growth and efficiency gains. IATA also notes that a long term approach to pricing will facilitate closer co-operation between the airlines and the service providers in determining new investments in infrastructure and the impact of such investments on cost.

⁸ Virgin Blue submission, 9 May 2003 p5.

⁹ *ibid*, p9.

¹⁰ Mackay Port Authority submission, April 2003 p6.

¹¹ Regional Aviation Association of Australia submission, 28 April 2003 p2.

6.4 Commission's preliminary analysis and conclusion

The Commission, in its July 2002 decision not objecting to Airservices' temporary price increases, provided a clear message to Airservices of its expectation that in future pricing proposals, Airservices would adopt a longer term view of price setting and allow for a thorough review of its cost structure.

The Commission therefore considers that Airservices' current pricing proposal should have articulated a plan for a long term price path. Instead, Airservices' proposal is for a second successive temporary price increase for 12 months, commencing from 1 July 2003. In addition the Commission and Airservices' customers have not been provided with an opportunity to thoroughly review Airservices' cost structure. For example, no detailed Optimised Depreciated Replacement Cost (ODRC) valuation of its asset base was provided, and detailed productivity studies benchmarking the performance of all Airservices' business units against best practice standards do not appear to be available.

In considering Airservices' current proposal the Commission recognises that current international uncertainties associated with international factors such as the war in Iraq and the SARS outbreak has made it difficult to develop accurate air traffic forecasts.

The Commission considers, however, that even in this current environment it would still be possible for Airservices to develop a longer term price path that would provide greater certainty on future pricing to Airservices' users. In particular the Commission notes that a number of aviation businesses in Australia and overseas operating in the same business environment as Airservices have been able to develop longer term pricing paths. In the Australian context the Commission is aware that a number of airports have recently concluded long term pricing agreements with airlines. The Commission is also aware that that the UK's air traffic manager NATS continues to operate under a long term price path. (See Appendix B for more discussion of international approaches to pricing of air navigation services).

The Commission considers that a longer-term price path provides much stronger incentives for Airservices to minimise the costs of providing its services than the current short-term approach. It is noteworthy that the period 1997 through to 2001 – in which Airservices achieved savings in annual costs in the order of \$100 million – coincided with a self-imposed commitment to real price reductions. That is, Airservices effectively imposed its own price cap.

A long-term approach would also represent a better sharing of risk than is currently the case. Airservices would bear more risk associated with the management of costs, as well as risk associated with the variability of activity over a number of years. Exposure to such risk is an important discipline on management decisions over the timing and extent of new investments.

A longer term pricing path should also lead to more stable prices over time. In contrast, Airservices' current annual approach to pricing - based upon achieving a given rate of return - is counter cyclical and likely to lead to price increases when demand falls and price reductions when demand increases.

Airservices' pricing proposal is of particular concern to industry as it involves an increase in a period when demand is still recovering from a particularly depressed level in 2002/03. In such periods of low demand, a price increase could have a more severe impact on users and activity levels. By contrast, price paths provide a smooth transition for airlines and other users, allowing them to plan investment, by mitigating against future shocks.

By way of illustration, the Commission notes that it would be possible for Airservices to levy a smaller price increase generating the same revenue (in present value terms) over a longer period. This would shift some of the burden to later periods when demand might be expected to be stronger. An example of this principle, as applied to the proposed TN increase, is detailed at Box 1.

BOX 1: Impact of Implementing Proposed 2003/04 Increases In Terminal Navigation Prices Over a 5 Year Time Period

This example identifies how it would be possible for Airservices to generate the equivalent revenue that it is currently proposing to generate in 2003/04 from increases in TN prices over a 5 year time horizon. The Commission has assumed a conservative activity growth forecast of 1% p.a. in its calculations.

Airservices' proposed price increases for Terminal Navigation (6.95% for most locations) would yield additional revenue of \$11.3m in 2003/04, and no more if prices then reverted to 2002/03 levels. An equivalent approach would be a constant rate of price increase of 0.6% per annum, accumulating for 5 years. This would yield the same value of discounted revenue (discounted at assumed nominal WACC of 9% pa). The amount of additional revenue over revenue at current prices would build from \$0.9m in 2003/04 to \$4.8m in 2007/08. Note that, to be equivalent to the temporary one-year increase, the price after 5 years would have to return to the original level.

Another approach equivalent to the temporary 6.95% would be a one-step increase in 2003/04, then holding the price at that level for 5 years. A price increase of 1.6% over the current price, yielding an additional \$2.6m a year for 5 years, would yield the same discounted revenue as Airservices' proposed temporary price increase.

Similar percentage price increases would apply for Aviation Rescue & Fire Fighting charges.

Certainty and stability of prices allows users of services to better plan efficient investments which is particularly important in the aviation industry given the size of "lumpy" investments required by airlines in high value assets such as aircraft. A long term price path should also provide better investment signals to Airservices than short-term rate of return regulation. Under short-term rate of return regulation a monopolist such as Airservices has weaker incentives to rigorously assess the value of an investment, which can lead to over-investment in capital as the cost of the investment can simply be re-couped through higher prices. A longer term pricing path would therefore ensure Airservices considers longer term activity levels when deciding upon investments.

A long term price path is also consistent with the principle of dynamic efficiency, which occurs when firms have appropriate incentives to invest, innovate and reduce costs over time. In an open and competitive economy, efficient provision of services underpins investment and employment opportunity. Welfare-enhancing investment and employment in the national economy will be promoted when firms produce goods

or services at least cost and charge prices which correspond as closely as possible to competitive levels. Although a competitive benchmark may be lacking in industries subject to price surveillance, economically efficient prices would, as in competitive areas, reflect least-cost production with profit margins allowing a normal rate of return on capital.

The Commission therefore considers that the development of a long term pricing model is achievable and would provide a level of certainty and flatten the impact of cyclical changes in activity levels on Airservices' charges.

The Commission encourages Airservices to work together with its customers towards the introduction of such an approach.

6.5 Response to Commission's preliminary view

BARA argues that Airservices has not provided sufficient information to enable Airservices' customers and the Commission to properly assess its pricing policy. In particular it argues that critical information on the valuation of the current asset base and operating structure has not been provided and unless further information is provided by Airservices a long term pricing model will not be achievable. BARA suggests that Commission not agree to any price increase "until Airservices makes proper disclosure and a firm commitment to a long term pricing policy"¹².

Virgin Blue states that the inefficient and sub-optimal outcomes generally associated with the provision of essential services by a monopoly provider can only be minimised if Airservices is subject to a long term pricing model that imposes genuine incentives on Airservices to reduce costs and increase efficiency over time. Virgin Blue argues that the Commission should not only object to Airservices preliminary pricing proposal in its final decision but should also propose that Airservices adopt a long term pricing model that incorporates an incentive mechanism, such as a CPI-X price cap.

Qantas argues that Airservices has not provided a convincing case justifying the current short-term approach to pricing compared to that recommended by the Commission. Qantas further suggests that Airservices' concerns relate largely to the level of demand and its effect on the return to its shareholder (the Government) and that this is a different issue to ensuring that Airservices has adequate funding to provide required services in a safe and efficient manner.

Qantas notes that the manner in which Airservices delivers its services directly affects the efficiency of airport and aircraft operations. Of concern to Qantas is the possibility that Airservices may seek to maintain its planned profit level in 2003/04 by reducing service standards that can affect the efficiency of aircraft operations.

Qantas also states that it would welcomes the opportunity to develop a longer-term approach to the provision and pricing of services by Airservices, consistent with the objectives of safety, efficiency and appropriate return on investment. The key elements of such an approach would include:

¹² BARA Response to Preliminary View 3 June 2003 p2.

- specification of services provided, including agreed service standards;
- estimated operating, maintenance and depreciation costs (by service) based on specified service standards and planned capital expenditure, including anticipated savings flowing from investment expenditure;
- an agreed capital expenditure programme. This programme needs to be developed in consultation with users consistent with the objectives contained in the Australian Air Traffic Management Strategic Plan;
- a pricing policy for unplanned expenditure to accommodate identified safety issues, changes to service standards, regulatory changes or other issues not covered in existing prices;
- agreed starting asset valuation and return on capital (weighted average cost of capital (WACC)); and
- activity forecasts based on individual services provided.

IATA fully endorses the Commission's view that Airservices should take a longer term approach to pricing that will take into account traffic growth and efficiency gains.

Airservices has stated that it is disappointed with the Commission's Preliminary View decision and in particular "its failure to recognise the significant voluntary efforts made by the corporation to reform its cost structures and share these benefits directly with customers over a number of years"¹³. Airservices argues "that if reaffirmed, this decision will undermine the progressive culture that has been cultivated over the past few years"¹⁴.

Airservices also states that while it had misinterpreted the Commission's views on the need for a longer term pricing approach its position is now that it is committed to forging a longer term pricing agreement with its customers and will endeavour to implement this outcome before the end of 2003-04. In the meantime, prior to a long term pricing agreement being reached Airservices argues that a temporary pricing arrangement is warranted to prevent the corporation from being financially penalised.

Airservices' preference is for a temporary pricing arrangement to increase prices at TN and ARFF locations as indicated in its draft pricing proposal. Airservices suggests that if this proposal is considered by the Commission to be unacceptable, then, in the alternative, it should allow maintenance of TN and ARFF prices at current levels and the temporary restoration of its en route prices back to July 2002 levels.

6.6 Commission's conclusion

As identified in the Preliminary View, the Commission considers that a longer term pricing framework should provide efficiency incentives for Airservices and stable prices for customers.

¹³ [Airservices Australia Final Submission 2003/04 Pricing Proposal 6 June 2003 p1](#)

¹⁴ [Ibid](#)

Pricing which, in the short run, increases as a result of falling demand appears to be a consequence of a firm having substantial market power. In this respect, the Commission has concerns that Airservices' approach is inconsistent with the criteria set out in s 17(3)(b) of the PS Act, which the Commission must consider in reaching its decision.

On the other hand, longer term pricing promotes productive efficiency by encouraging Airservices to provide services at the lowest possible cost. Similarly, dynamic efficiency is enhanced as pricing cannot be simply adjusted to provide returns on investments the year after they are made. Rather, when considering the timing of investments, Airservices must take into account the expected changes in demand over a longer period of time.

Prices that take into account changes over a reasonable future period also promote allocative efficiency as users face prices that are less likely to reflect excessive costs. This contributes towards efficient investment and employment in these markets, and thus promotes the criteria of s 17(3)(a) of the PS Act.

The Commission notes that Airservices' customers are supportive of working with Airservices to develop a long term pricing model. The Commission also welcomes Airservices' public commitment to develop a long term pricing model and its intent to implement this outcome before the end of 2003/04.

The Commission considers any long term pricing framework should be forward looking. Within this context it would expect that previous efficiency gains and cost savings achieved by Airservices to only have limited significance in the setting of parameters for future prices .

The Commission notes Airservices' claim for a further temporary increase in prices but considers that the Commission's 2002 decision had already provided a clear message to Airservices of its expectation that in future pricing proposals, Airservices would adopt a longer term view of price setting and allow for a thorough review of its cost structure.

The Commission does not consider it appropriate for any further direct increase in prices to be implemented at this stage but does not oppose Airservices' current prices remaining in place until June 2004. In agreeing to current prices remaining in place for a further year it is the Commission's expectation that this timeframe should provide an opportunity for Airservices to develop a long term approach to pricing in consultation with its customers.

Although not formally covered by the Airservices price notification, the Commission would consider any increase to en-route charges to be more difficult for Airservices to justify than the increases to terminal navigation and ARFF charges already proposed. In particular the fact that en-route services are significantly more profitable than terminal navigation and ARFF services (refer to section 13.4) suggests the case for increases to en-route charges is weaker.

While the Commission notes Airservices' comment that such a decision "will undermine the progressive culture that has been cultivated over the past few years", it remains unclear as to how the Commission's decision not to oppose the maintenance of Airservices' current prices and to encourage the development of a long term pricing model in consultation with customers would adversely effect the "progressive culture" within Airservices.

7 Dual Till/Multi Till pricing

7.1 Introduction

As noted earlier, the building block methodology has been used by the Commission in various industries to assess the revenue required for the provision of a regulated service, giving consideration to the need for the declared company to earn a reasonable rate of return. Utilising the required revenue and forecast activity, proposed price increases are then assessed.

Under a single till approach an organisation is considered in its entirety and on this basis the inputs into the required revenue calculation are the total assets and the total operating and maintenance costs required for the provision of all services. The dual till approach, in contrast, separates regulated and non-regulated services. It then determines the required revenue for the regulated services by reference to those assets used for the provision of that service and costs directly attributable to the service, plus an allowance for joint costs.

The Commission in its 2002 decision recommended that Airservices move away from single till pricing and give consideration towards the adoption of a multi-till approach (which would separate en route navigational services, location specific terminal navigation services and location specific aviation rescue and fire fighting services). The Commission in this decision also identified that if a multi-till approach were to be adopted a detailed analysis of the allocation of assets, costs and revenues across services and locations would be required.

7.2 Airservices' initial position

Airservices has assessed its temporary 2003/04 pricing proposal using a dual till approach within the building block methodology. Under this dual till approach there has been a separation of the assets and operating and maintenance related building blocks into regulated and unregulated service lines.

According to Airservices this is the first step in moving toward the adoption of a multi-till approach that would further divide the regulated services into its component service elements.

Airservices adopts a predominantly activity-based approach to the determination of costs by service and location. Airservices claims that this ensures that the prices of specific services and locations align with the organisation's pricing philosophy of 'user pays', and supports capital investment decision making.

The allocation of costs to unregulated services is achieved through either the direct costing of an independent function (eg staff and consumables for Airservices Australia's Publications Centre), or on an activity basis that includes the use of timesheets and quantity drivers (eg CPU seconds for IT usage). Group and corporate overheads are allocated to this till on a basis consistent with that applied to the regulated business till.

In allocating costs to the individual regulated services at particular locations, a mix of direct costing, activity based allocation and generic allocations are applied.

Airservices states that the cost allocation methodologies for each regulatory cost type are as follows:

Directly Costed	50% of regulated service costs can be directly attributed to a particular service and location. This includes the air traffic controllers at a particular tower and the rescue and fire fighters at a particular station and depreciation of assets that are solely attributable to a service location.
NAS Services	The National Airway System (NAS) is the technical asset infrastructure supporting air traffic services. This includes radars, navigation aids, towers, radios and operational software. NAS services refers to the cost of technical maintenance and support of this infrastructure, amounting to some 19% of the regulated services costs. These costs are allocated on activity based costing principles using sophisticated technical maintenance scheduling software applications.
Shared Services	Shared services account for approximately 7% of regulated services costs and include non-operational communication and data services, transaction processing (eg. accounts payable, accounts receivable, payroll) and information management services. These costs are allocated using activity based costing principles, and include drivers such as transaction usage quantities and timesheets.
Corporate Initiatives	These costs represent around 7% of regulated services costs and reflect corporate overheads and specific organisation wide services. They are allocated using direct costs as a generic allocation basis.
Specialist Support	Specialist Support costs amount to 18% of regulated services costs and include operational recruitment, training, procedures design and roster management, local human resource and financial management and day-to-day operational management.

In total, approximately 85% of the regulated costs are allocated on a direct or activity cost basis. The remaining 15% (consisting of all corporate costs and over half of specialist support costs) largely reflect common or joint costs for which it is not possible for Airservices to provide a consistent nexus between the cost being incurred and the service at a specific location.

7.3 Views of interested parties

Qantas argues that single till pricing is the appropriate methodology that should be adopted by Airservices. According to Qantas a single till would enable Airservices to earn a reasonable return on overall assets and also allow Airservices to promote the

general health of the aviation industry by ensuring any excess revenues from Other Business Activities (OBAs) are passed back to users.

In support of its position, Qantas argues that there are important differences between the provision of non-aeronautical services by airports compared to OBAs by Airservices. Qantas argues there is little comparison between the non-aeronautical activities of airports where the retail merchandising etc require a different set of experience, skills and knowledge to that necessary for the core regulated business. According to Qantas this contrasts with Airservices' OBAs that are only possible because of the funding, skills and knowledge that it obtains from the provision of core ATM functions.

Qantas further claims that for dual till pricing to be applied appropriately, it is necessary to allocate part of the cost associated with providing core ATM functions to costs associated with OBAs such as contracts gained overseas. However Qantas argues that Airservices has not provided the data for industry to make a considered assessment of the appropriateness of the allocation of overhead costs between the 'normal' business activities that are to be funded by the airlines, and the allocation to the OBAs.

IATA supports Airservices' use of the dual till system enabling a breakdown of service line profitability.

BARA argues that by moving from a single till to a dual till pricing structure Airservices' performance with regard to operating costs has become clouded.

7.4 Commission's preliminary analysis and conclusion

The Commission does not consider that single till pricing should be applied to Airservices. The Commission's view is that under a single till approach there may be less incentive for Airservices to minimise risk in relation to its OBAs. This is mainly because under a single till system any losses from OBAs could in effect be directly funded by other customers of Airservices through higher charges for regulated services. Consequently, a single till approach may lead to inefficient investment levels. The Commission therefore considers that it is in the best interests of users for Airservices to use dual till or multi-till pricing and to take direct responsibility for managing the risk and returns of its investment in OBAs.

The Commission therefore endorses Airservices decision to move from a single till to a dual till system as a first step in moving toward the adoption of a multi-till approach.

The adoption of a multi-till approach was recommended in the Commission's 2002 decision (which would separate en route navigational services, location specific terminal navigation services and location specific aviation rescue and fire fighting services) and would be consistent with Airservices' location specific pricing and the potential future contestability of terminal navigation and aviation rescue and fire fighting services.

The Commission encourages Airservices to continue to give consideration to the adoption of the multi-till approach in future pricing proposals.

On a related issue the Commission notes Qantas' concerns regarding Airservices' procedures for allocating costs between its regulated ATM functions and its non-regulated OBAs. In considering this issue the Commission's view is that the following points are relevant:

- only 15% of Airservices' regulated costs are not allocated directly or on an activity basis – which means that only a small proportion of costs are likely to raise issues; and
- Airservices has relatively few OBAs.

The Commission therefore considers that issues relating to the allocation of costs between Airservices' regulated ATM functions and its non-regulated OBAs will be relatively minor.

7.5 Response to Commission's preliminary view

BARA and Qantas identified their support of multi-till pricing by Airservices.

Qantas also, however, argues that Airservices should be required to disclose financial statements with accounting separation of OBAs. Qantas claims this will enhance the accountability of Airservices' OBAs to Government and the wider industry.

7.6 Commission's conclusion

The Commission confirms its Preliminary View assessment to endorse Airservices' move from a single till to a dual till system as a first step in moving toward the adoption of a multi-till approach.

The Commission also encourages Airservices to continue to give consideration to the adoption of the multi-till approach in future pricing proposals.

8 Cost structure efficiency

8.1 Introduction

Operating and maintenance costs play a critical role in determining the required revenue for a declared service and, as a result, the efficiency in which those costs are incurred is a key consideration for the Commission.

In the 2002 decision the Commission noted the absence of any detailed information from Airservices on the efficiency of its cost structure but decided on balance not to object to the proposed operating and maintenance costs for 2002/03. In reaching this view the Commission took into consideration the mitigation strategies implemented by Airservices and its efforts to remove previous operating inefficiencies.

8.2 Airservices' initial position

Airservices has not in its current preliminary pricing proposal provided detailed supporting information to verify that its operating and maintenance costs are at efficient levels.

Airservices has identified that in 1997/98 it embarked on a 5 year business transformation (BT) process, which aimed to reduce real prices by 20%, cut costs by \$100m and double profitability within five years. These objectives were achieved two years early and Airservices has further noted that its real prices declined each year since the commencement of BT until 2002/03 when real prices increased.

Airservices has also made reference to its history of sharing gains with customers and specifically noting that a one-off windfall gain in 2002/03 arising out of the cross border QTE leasing arrangement enabled the early reversal of en route prices, bringing the reduction forward by 6 months and saving the industry in the order of \$5m.

Airservices has identified that it is expecting that costs in 2003/04 will increase by \$17.2 million or some 3.4% above planned 2002/03 expenditure levels.

This increase in Airservices' costs is mainly attributable to the impact of pay rises, totalling some \$13.5 million. Further extraordinary costs of \$7.1 million (offset in part by savings of \$3.5 million) have been identified as a result of higher superannuation contributions of \$4.0 million, resulting from the downturn in investment markets, increased insurance premiums of \$1.6 million, and the net impact of regulatory changes affecting the level of ARFF operations (\$1.5 million).

In providing this information Airservices has identified its difficulty in determining the efficiency of its cost structure and has pointed to a number of benchmarking exercises it has been involved with. According to Airservices these studies have both identified areas where they are performing well, and provided a stimulus to drive innovation to improve performance.

8.3 Views of interested parties

BARA and Qantas have stated that they share the concerns identified last year by the Commission about the lack of evidence of the efficiency of Airservices' capital and operating cost structure and that Airservices' current proposal fails to address these concerns.

BARA notes that Airservices has made some efforts to share information with users about its capital program but more detailed analysis is required. BARA argues that the relationship between Airservices' capital and operating cost structure is complicated and is largely driven by the capacity of Airservices to make certain investments that significantly reduce its operating costs through capital/labour substitution.

BARA while acknowledging Airservices' efforts to reduce costs in the past argues that no evidence has been presented in this or previous proposals to show that, either on a location or network basis, Airservices has reached a capital or operating base that is efficient. Moreover, the lack of a forward looking pricing policy gives BARA no confidence that Airservices has in place any incentives to reach the optimal structure of production for the services it provides users.

BARA recommends that the Commission obtain the information it felt was necessary last year to properly assess Airservices' efficiency prior to making any decision on the matter now before it. That information should be shared with users so that a proper technical evaluation can be made.

Qantas makes the point that while operating and maintenance expenditures account for the majority of its total costs, the level of such costs are strongly influenced by Airservices' capital program and that many previous cost reductions by Airservices were generated through the introduction of capital investments, such as the Australian Advanced Air Traffic System (TAAATS).

Qantas notes that Airservices has attempted to increase transparency in relation to its capital expenditure program but suggests further improvements in this process are required. Qantas argues that under current processes, many of the capital projects undertaken by Airservices purport to generate efficiencies or cost savings through their implementation, though often no financial information on such savings is provided. Combined with the current short-term price-setting arrangements, Qantas is therefore not confident that cost savings - used in part to justify certain capital projects to Airservices' board - are actually reflected in the proposed operating and maintenance costs.

Virgin Blue notes that there is currently no transparency in ASA's cost allocation structure. They also argue that Airservices has not provided any evidence in its preliminary pricing proposal about the extent to which costs for the provision of TN and ARFF services have increased at particular airports. Virgin Blue also "submits that the ACCC should not consider approving any proposed increase to TN and ARFF

charges until Airservices provides more (meaningful) information about its cost allocation structure”¹⁵.

BARA also argues that Airservices should adopt a longer term view of price setting and allow for a thorough review of its cost structure in future notifications. According to BARA this is the only way to ensure that Airservices’ cost base is efficient and that the benefits of future investment properly flow through into better price and quality outcomes for users. BARA claims Airservices’ current approach to pricing effectively mimics single period rate of return regulation and delivers most of the problems generally predicted from that approach.

Qantas suggests that given its monopoly position Airservices should be subject to pricing arrangements that encourage and reward improvements in long-term cost efficiency. According to Qantas this requires the development of a price path which is based primarily on current costs but also incorporates anticipated improvements in productivity and growth in traffic volumes.

Qantas also argues that an examination of Airservices’ capital program, combined with other initiatives due for implementation that there is sufficient evidence to justify the Commission applying an efficiency dividend of 4% to Airservices’ proposed operating and maintenance costs.

The MPA suggests that Airservices should be more transparent about its cost and revenue requirements. It also notes that in New Zealand the introduction of competition for fire fighting services has led to a reduction in the prices of these services.

8.4 Commission’s preliminary analysis and conclusion

The Commission recognises the cost mitigation strategies that Airservices has implemented in recent times and the reductions in certain costs that have occurred.

The Commission notes that Airservices has provided information on benchmarking studies which provides an insight into productivity levels within Airservices. In particular, information provided to the Commission suggests that Airservices’ technical support services provides a high quality service but at a cost that is somewhat higher than best industry practice.

Airservices has also provided details of benchmarking studies which compares its performance with air traffic managers in the USA (FAA) and Europe (Eurocontrol). This information supports an assessment that Airservices’ Air Traffic Management (ATM) system, although smaller, is more cost effective than its European and US counterparts. This study also suggests that Airservices has relatively low employment and support costs in comparison to counterparts in the USA and Europe. More importantly, the study suggests Airservices is relatively efficient on a number of measures, including measures of controller productivity and the ratio of support staff per air traffic controller employed.

¹⁵ Virgin Blue submission, 9 May 2003 p5.

While the international productivity studies supplied by Airservices support an assessment that Airservices is internationally efficient when compared to government owned and controlled air traffic managers in the USA and Europe, this provides only a limited insight on the relative international efficiency of Airservices' operations. A benchmark assessment of Airservices' efficiency on an international basis would be further assisted by comparisons of its performance with more commercially oriented air traffic managers; for example in countries such as New Zealand, South Africa and the UK.

The Commission has also been provided with some benchmarking studies of Airservices' ARFF services which suggests that Airservices' staff resourcing for these functions compares favourably with resourcing levels applied to airport fire-fighting in Europe, the UK and the USA.

Overall the Commission considers that the information provided on productivity levels is insufficient to enable an assessment to be made that Airservices is operating and incurring costs at efficient levels, and has incentives to continue to do so. In order to make any preliminary conclusions that Airservices is operating at an efficient level the Commission would need to be provided with detailed information benchmarking the performance of **all** significant business units within Airservices against relevant best practice standards.

Alternatively, studies of historical and/or forecast total factor productivity may provide insights into Airservices' efficiency performance, especially given the potential for capital/labour substitution within the business. These could be conducted at an aggregate business level and/or for specific service lines.

The relationship between capital costs and ongoing operating and maintenance costs is clearly important. Airservices has a relatively high level of operating costs compared to other regulated monopolies, with these comprising around 82% of the total cost estimates submitted by Airservices.

The Commission notes that Airservices has made attempts to improve the level of transparency around its capital expenditure budget through consultation with users. However, the Commission also recognises that users have a strong interest in being provided with additional information that specifically identifies how future savings associated with the purchases of new capital equipment are being reflected in Airservices' cost structure.

With the information provided, the Commission remains unable to satisfy itself that Airservices' costs have been efficiently incurred. In particular the Commission emphasises its concerns regarding the absence of any formal incentives for Airservices to reduce costs and to become efficient. The Commission considers that efficiency incentives could and should be built into Airservices' pricing structure and that one mechanism to achieve this would be through a longer-term pricing approach.

8.5 Response to Commission's preliminary view

BARA identifies its concern about the efficiency of Airservices' operating cost base. In particular it identifies a concern regarding the lack of information provided about

the relationship between Airservices' operating costs and its capital program. BARA also concludes that information provided on Airservices' productivity levels relative to the FAA and Eurocontrol is insufficient to conclude that Airservices is incurring costs at efficient levels.

BARA supports a broader and independently conducted international study being undertaken to assess the relative international efficiency of Airservices' operations. It also agrees with the Commission's conclusion that an incentive mechanism needs to be developed that ensures operating cost efficiency, and that this can be achieved through a long term price path.

Virgin Blue comments that Airservices' unwillingness to provide information about its cost structure prevents the Commission and interested parties from determining whether Airservices' costs have been efficiently incurred. The benchmarks referred to by Airservices in its response to submissions also did not demonstrate to Virgin Blue that Airservices' costs have been efficiently incurred. Virgin Blue concludes that it wholly agrees with the Commission's observation in its Preliminary View regarding Airservices' cost structure efficiency.

Airservices has provided some benchmarking comparison between Airservices, FAA and Eurocontrol which indicates that Airservices out performs on a productivity basis these other two other providers. Airservices has also provided some benchmarking of its prices with more commercial air traffic managers in New Zealand, South Africa and Canada. According to Airservices these studies demonstrate that, from a pricing perspective, Airservices is operating at efficient and competitive levels by world standards.

Airservices also reiterates its past achievements in reducing costs and argues that it has achieved greater efficiency gains than airports were able to achieve over the same timeframe under a CPI-X price path.

8.6 Commission's conclusion

The Commission recognises that Airservices has provided some additional benchmarking studies comparing its pricing performance with more commercially oriented air traffic managers in New Zealand, South Africa and Canada. The Commission, notes however, that differences in prices between countries will also reflect differences in cost levels eg wage levels and that this limits their usefulness. In contrast efficiency benchmarking can provide comparative information on the real level of resources required to produce a given output eg average number of air traffic controllers employed per scheduled flight. As a consequence without supporting efficiency benchmarking studies, the Commission is unable at present to make an assessment of the relative international efficiency of Airservices operations.

The Commission would therefore encourage Airservices to undertake some independent and reviewable benchmarking studies with commercially oriented air traffic managers which might further clarify the relative international efficiency of its operations. Airservices could also consider the use of total factor productivity techniques such as data envelope analysis to analyse the relative efficiency of Airservices' operations against international best practice standards.

Furthermore in order for the Commission to make an assessment that Airservices is operating at an efficient level any benchmarking must be broad enough in scope to allow some assessment across - **all** regulated activities.

Overall the Commission considers that the information provided on productivity levels remains insufficient to enable an assessment to be made that Airservices is operating and incurring costs at efficient levels, and has incentives to continue to do so. The Commission considers that efficiency incentives could and should be built into Airservices' pricing structure and that one mechanism to achieve this would be through a longer-term pricing approach.

9 Asset valuation

9.1 Introduction

In its 2002 price proposal Airservices argued that the book value of its assets underestimates the value that would be obtained under an ODRC methodology. Airservices further argued that the application of an ODRC methodology to Airservices' assets would result in value of assets 10 % above their book value.

The Commission in its 2002 decision identified its concerns that it was unable to independently verify Airservices' claim in relation to its asset values. In agreeing to allow a 10% addition to the current written down value of assets the Commission noted the risk of undervaluing assets outweighed the danger of overvaluing after consideration of the risk involved. That is, if the value accorded to Airservices' asset base was below the value on which it should be earning a rate of return, then there was a risk that the incentive for investment in these assets would be reduced and, in turn, a risk that services or standard of services will be reduced.

In agreeing to this approach the Commission also noted Airservices' intention to provide the Commission and its customers with further information regarding the valuation of assets in future pricing proposals.

9.2 Airservices' initial position

Airservices has not specifically addressed the issue of the valuation of its assets in its current submission other than to state it has continued to use a 10% addition to the current written down value in determining its required rate of return.

However following a request from the Commission, Airservices subsequently provided a report which updates the information provided to the Commission in 2002 in relation to the impact of applying the ODRC methodology to Airservices' regulated asset base.

The principal finding of this report suggests that Airservices' asset base is undervalued by almost 80% if an ODRC basis of valuation was adopted. Airservices further states that over the last 10 years, the primary focus of asset investment has been the air traffic management system replacement (TAAATS). However over the next 5 years, the communication, navigation, surveillance and fire vehicle assets will begin to be replaced. Airservices argues that these have been valued conservatively for accounting purposes. Airservices also notes that tower and fire station assets are 20 to 30 years old and are likely to be progressively replaced in 5 to 10 years. According to Airservices these assets have also been conservatively valued for accounting purposes.

Views of interested parties

Qantas argues that while the Commission has often used ODC to establish the starting value of the asset base, new capital expenditure is usually included at acquisition costs.

Qantas further argues that the reasons the Commission has previously put forward for choosing ODRC do not appear applicable in the case of Airservices' fixed assets. Specifically it suggests that:

- Airservices has not sought to justify such an approach based on any poor or inconsistent accounting practices;
- While Airservices has undergone significant change over the past decade, such as its Business Transformation Program, there is little evidence that this was done at the expense of appropriate attention to asset valuation;
- Airservices has not been subject to vertical or horizontal separation of its asset base and Airservices remains the legislated monopoly supplier of TN, Enroute and ARFF services for Australia;
- Other than non-priced Defence equipment, there are no similar assets in any other Australian jurisdictions generating any comparative valuation issues; and
- Technical obsolescence is not a significant issue for asset valuation purposes for Airservices.

Qantas therefore concludes that there is little justification for choosing ODRC to value Airservices' assets based on reasons justifying its use in other infrastructure industries.

Qantas also notes that the main feature of Airservices' fixed assets is the high proportion of investment and depreciation each year compared to total fixed assets. Most of Airservices' assets are high technology assets with a short economic life. As a consequence, a significant portion of Airservices' existing asset base is largely depreciated and replaced with new assets, within a relatively short time frame.

Qantas therefore argues that assuming Airservices has correctly accounted for its assets over the past few years, the majority of the asset base does not require an ODRC valuation. Rather it should be treated the same as planned capital expenditure and valued at acquisition cost, written down for depreciation. By applying a 10% increase in valuation across all assets, an arbitrary and inappropriate increase is applied to assets with known acquisition costs.

According to Qantas the current approach to asset valuation for pricing purposes by Airservices should not be allowed to continue and a robust method for determining the starting asset values and changes to the asset base needs to be implemented. However Qantas also notes that if the Commission has insufficient time to adopt a robust assessment of Airservices' asset base, then, for the purposes of this pricing submission, it is appropriate that the Commission makes some adjustment to Airservices' valuation technique. Qantas argues that the majority of the asset base should have known acquisition values so, at a minimum, 50% of the asset base should be valued on its book value and only the remaining 50% on the previous methodology. This would reduce the overall increase on book values to 5%.

BARA notes that there is nothing to suggest in Airservices' current pricing proposal that it has taken up the Commission's 2002 recommendation that Airservices review its asset base and cost structure in future pricing proposals. BARA further argues that it is not possible to ascertain from the current proposal whether Airservices is still loading 10% onto the written down value of its assets to bring them to what it

considers to be their ODRC value. BARA suggests that given Airservices' failure to properly address the Commission's concerns in relation to its asset base raised last year, any loading applied to the written down value should be treated as an unsubstantiated ambit claim and the asset base taken as the written down value. Beyond that, BARA sees no systematic reason why it should be concluded that the written down value should be "written up", especially given the common experience of technological change to drive down the costs of a range of basic equipment used by Airservices, such as computer CPUs and displays.

9.3 Commission's preliminary analysis and conclusion

Under the building block approach the value of assets can have a significant impact upon the revenue required to provide regulated services. In Airservices' current pricing proposal the impact of a 10% increase in the written down value of assets translates to an increase of around \$8 million in annual revenue for Airservices.

By way of comparison, the current pricing proposal, which involves a general 6.95% increase in TN and ARFF prices, will generate approximately \$16 million in annual revenue for Airservices. A 10% increase in asset values would therefore be approximately equivalent to around a 3.5% price increase in TN and ARFF charges, all other things being equal.

The Commission is therefore disappointed that Airservices has not provided more detailed and timely information to independently verify the value of its assets despite being advised last year of the Commission's concerns about this issue.

There are two particular issues here. The first relates to the adequacy of Airservices' ODRC valuation, while the second relates to the circumstances in which an ODRC valuation is the appropriate basis for pricing.

On the first issue, the Commission is concerned that the asset valuation report provided confidentially to the Commission was not tabled as part of the pricing proposal and that it has therefore been provided with very limited time to consider and test it. The Commission notes, however, that this report is pitched at a high level without the degree of detail contained, for example, in ODRC studies previously provided to it by the Sydney Airports Corporation Ltd (SACL).

Furthermore the Commission would normally expect an ODRC study to contain more detailed independent analysis on what assets a service monopoly provider should optimally hold to achieve best practice in service delivery.

The Commission also notes the difference between the process followed by Airservices in the current price notification and the determination of ODRC asset valuations to that adopted by SACL in its 2000 aeronautical pricing proposal to the Commission. In that process, SACL provided the Commission with a detailed independent ODRC study as part of its pricing proposal. It then provided the Commission with the opportunity to engage its own consultant to assess the ODRC valuation, agreed to provide airlines with access and to engage their own consultants to review the report. On this point, the Commission has some concerns about the

apparent lack of consultation with Airservices' users in relation to its proposed asset valuations.

Given that the Commission only received the asset valuation report from Airservices on 6 May 2003 it is therefore unable to make an assessment of whether the ODRC valuation of Airservices' assets is acceptable.

The second issue raised above relates to the circumstances in which an ODRC valuation is the appropriate basis for pricing.

The Commission acknowledges the view put by Qantas that an ODRC valuation should not be applied to Airservices' asset base. However the Commission considers that the points it identified in its 2002 decision are still relevant and could justify the use of an ODRC valuation. Specifically the Commission is of the view that:

- using the current written down book value may not provide Airservices with sufficient incentive to innovate, as it claims to have done when developing TAAATS; and
- the use of ODRC can minimise the likelihood of significant shocks to price as replacement of the assets becomes necessary.

The Commission also considers that the use of ODRC asset valuations is consistent with the objectives of achieving greater price stability through long term pricing path for Airservices. However, the Commission's view is that the principles underpinning ODRC should be applied consistently by Airservices across its operations. This means that Airservices should only recover from users revenues sufficient to cover costs efficiently incurred.

While the Commission acknowledges that an ODRC valuation of assets could be higher than the current written down book value of assets, adopting this approach might have implications for an assessment of the efficiency of ongoing operational costs. For example, higher values for replacement of very old assets could be expected to significantly reduce ongoing maintenance costs.

In this respect, should an ODRC valuation be applied to Airservices' assets, the Commission would expect corresponding detailed information on the effects of such a valuation on operating and maintenance costs.

In making an assessment of the appropriate valuation that should be applied to Airservices' assets the Commission remains in the same position as it was in 2002. The Commission therefore strongly encourages Airservices to undertake further analytical work in consultation with industry representatives to determine what valuations should be applied to Airservices' assets for the purposes of establishing prices over the medium term.

9.4 Response to Commission's preliminary view

BARA notes its concern about not being provided with Airservices' ODRC asset valuation report. BARA also stated its surprise that this ODRC valuation could be 80% higher than the written down value of assets. According to BARA to properly

progress negotiations over a long term pricing agreement Airservices will need to provide a robust ODRC valuation with an associated set of optimised operating costs.

Qantas argues that given the importance of operating and maintenance costs to Airservices' total cost structure, there is little evidence to suggest that applying an ODRC methodology to those services provided by Airservices will imply higher allowable revenues than those based on the book value of assets and current operating and maintenance costs.

Qantas endorses the Commission's recommendation that Airservices should undertake further analytical work in consultation with industry representatives to determine what valuations should be applied to Airservices' assets for the purposes of establishing prices over the medium term. Qantas also notes that difficulties in determining an appropriate asset value for pricing purposes may require innovation and compromise by Airservices and users. However, once established, additional investment by Airservices can be incorporated into the asset base at actual costs. According to Qantas the short economic life of many of Airservices' high technology assets means that the asset valuation issue can be largely resolved within a few years.

Airservices notes the asset value information provided to the Commission could not be independently verified in the time available and had not been prepared to the level of detail required by the Commission. Airservices acknowledges that asset valuations will form an important input into the determination of a medium term pricing proposal and that Airservices is committed to working with its customers to resolve these issues. Airservices also advises that detailed consultation on proposed capital expenditure programs have also commenced in support of this commitment.

9.5 Commission's conclusion

The Commission considers that asset values and their relationship to operating and maintenance costs to be important inputs into the determination of a medium term pricing proposal. The Commission's view is that the principles underpinning ODRC should be applied consistently by Airservices across its operations. This means that should an ODRC valuation be applied to Airservices' assets, the Commission would expect corresponding detailed information on the effects of such a valuation on operating and maintenance costs.

The Commission welcomes Airservices commitment to work with customers on this issue.

10 Return on capital

10.1 Introduction

The return on capital is a component of the building block model that ensures that both debt and equity holders are rewarded with a rate of return that reflects the opportunity cost of capital. In calculating the required rate of return, the building block model estimates a number of parameters to determine both the cost of debt and the cost of equity capital. It weights these costs in accordance with the capital structure to determine the weighted average cost of capital.

The two components of the WACC are the cost of debt and the cost of equity. The cost of debt in the WACC formulation is the expected return to debt holders on debt capital invested and is calculated as the sum of the nominal risk free rate and the cost of debt margin. The cost of equity capital to a firm is the rate of return required by equity holders given the opportunity cost of investing in the market, the volatility of the market and the systematic risk of holding equity (β_e).

10.2 Airservices' initial position

The parameters proposed by Airservices in its 2003/04 pricing proposal reflect the Commission's views in its Position Paper released in July 2002. In its 2003/04 preliminary pricing proposal Airservices states that:

The elements underpinning the estimation of an appropriate weighted average cost of capital reflect the Commission's decision in the 2002 price notification assessment, 12 months ago. However, the risk free rate and the debt margin have been updated to current rates.¹⁶

For a more detailed discussion of specific parameters used to estimate the WACC refer to the Commission's 2002/03 Airservices decision.

10.3 Views of interested parties

In relation to Airservices' estimate of the return on capital, the only issue raised was the appropriateness of an asset beta of 0.7.

Qantas and BARA are of the view that the asset beta should be lower than the asset beta of 0.7 proposed by Airservices Australia in its 2003/04 draft notification. In its submission Qantas suggests that an appropriate asset beta could be in the range of 0.4 to 0.5. It states:

This (asset beta range) is still higher than observed betas (infrastructure companies) but lower than that adopted for airports, reflecting the different approach to price setting and risk sharing adopted by Airservices¹⁷.

In its submission BARA also suggests an alternative asset beta than the one proposed by Airservices. BARA is of the view that the relevant asset beta should be 0.46 on the

¹⁶ Airservices Australia (1), *opcit.*, p10.

¹⁷ Qantas submission, April 2003. p9.

basis that Airservices Australia has signalled that a further price increase may be necessary to maintain a commercial rate of return. BARA notes in its submission:

Clearly, Airservices behaviour and its foreshadowing of a potential further price increase are clear indications that AA's shareholder is not bearing the same level of risk as airport stakeholders when the ACCC adopted 0.7.¹⁸

In its submission, BARA argues that given that Airservices faces relatively less risk than an airport operator, a more appropriate benchmark may be one that is based on an industry wide average of listed infrastructure and utilities companies, i.e. 0.46. This is the value set out in the Commission's position paper, *Government Mandated Security Requirements*¹⁹, released in March 2000.

Both Qantas and BARA are of the view that the signalling of future price increases by Airservices indicates a shift in its risk exposure and thus the asset beta should be lower than the 0.7 used by the Commission in last year's decision and proposed by Airservices Australia this year.

10.4 Airservices' response to submissions

In its response to submissions Airservices is of the view that the weighted average cost of capital should reflect the following aspects of its operations in comparison to airports:

Aviation revenues, based on variable units of activity, account for less than 30% of total revenues at Brisbane and Melbourne airports, the remainder is primarily property related, which are typically medium to long term fixed lease payments. In contrast, over 90% of Airservices Australia's revenue is based on variable units of activity.²⁰

The response therefore suggests that Airservices' revenue streams are more variable than an airport operator.

10.5 Commission's preliminary analysis and conclusion

The equity beta referred to in section 10.1 represents the relationship between the movement in the cost of equity and movements in the market due changes in economy wide factors (the systematic risk exposure of a firm). In the case of unlisted organisations, the estimation of an equity beta is problematic. To determine an equity beta a proxy asset beta is used. The equity beta is derived using the asset beta and allowing for gearing using the Monkhouse formula.²¹

¹⁸ BARA submission, April 2003, p5.

¹⁹ BARA submission, April 2002, p2. and ACCC (3), *Government Mandated Security Requirements, Position Paper*, March 2000, pp4-5. The original source was an IPART discussion paper the reference is IPART, *The rate of return for electricity distribution networks*, Discussion Paper, November 1998, p32.

²⁰ Airservices Australia (3), *Response to submissions regarding its 2003/04 Pricing Proposal*, May 2003, p3.

²¹ The formula for calculating the equity beta is that derived by Monkhouse for a business which has active debt management designed to maintain a specific debt/equity ratio:

$$Be = Ba + (Ba - Bd) \{1 - (rd / (1 + rd)) (1 - g) Tc\} D/E$$

The asset beta measures the systematic risk exposure of an asset. Systematic risk is defined as the co-variance between economy wide returns on an asset. An asset beta of less than one indicates that the variability of returns generated from an asset is less co-related to changes in economy wide factors.

A number of possible methods can be used to establish a proxy asset beta. These include:

- through the use of comparable organisation's asset beta; and
- through an estimation of income elasticity of demand.

The rest of this section is devoted to discussion regarding the appropriate asset beta for Airservices Australia as both the BARA and Qantas submissions provided an alternative asset beta than the one proposed by Airservices Australia.

The Commission considered the issue of the appropriate asset beta in its decision regarding Airservices Australia pricing proposal for 2002/03 released last year.

10.5.1 The Commission's view - 2002

In its previous assessment of the appropriate asset beta for Airservices, the Commission used a combination of both approaches described above. Firstly, the Commission considered the range in which the asset beta should lie, by reference to a group of comparable listed companies, and then used this range to determine a proxy based upon the risk characteristics of the organisation relative to the range. The Commission considered that the appropriate range for the asset beta was between 0.55 and 0.75 based on a comparison of asset betas used in previous aeronautical pricing decisions. This range also accounted for difference between Airservices' operating environment and that of airports.

Secondly, the Commission assessed Airservices' proxy which was established through the estimation of the correlation between en-route activity (measured in tonnes per kilometre) and GDP. The Commission noted that relying on the correlation between en route activity and GDP as a basis for the asset beta was problematic. Weight-based charges, as opposed to per passenger charges, decrease the sensitivity of changes in revenue to changes in income (GDP). The relationship between the asset beta and the income elasticity of demand is therefore lessened as a result of Airservices' weight based charge structure.²²

On the basis of arguments put forward by Airservices, Qantas, and BARA the Commission decided that an asset beta of 0.7 was likely to reflect the systematic risk of Airservices' returns.

Peter Monkhouse, "Adapting the APV valuation methodology and the beta gearing formula to the dividend imputation tax system", *Accounting and Finance* v37, 1997.

²² ACCC (4), *Airservices Australia Proposed Price Increase Position Paper*, July 2002, p40.

10.5.2 Commission's Preliminary View - 2003

In submissions to the Commission, BARA and Qantas provide alternative asset betas than the one proposed by Airservices. Qantas and BARA suggest that the asset beta should be lowered on the basis that Airservices is attempting to insulate itself from the revenue volatility associated with changes in activity levels with its short term pricing policy. The parties note that in its current notification, Airservices has signalled further price increases, should activity levels fall significantly as a result of the war in Iraq and the SARS virus.

The self imposed short-term counter-cyclical pricing policy of Airservices limits the systematic risk exposure of Airservices revenue stream to downturns in economic activity. The pricing policy of Airservices is analogous to constant rate of return regulation. In both cases a rate of return is maintained from year to year by adjusting prices given changes in demand (activity levels).

The asset beta proposed by Airservices may need to be revised downwards given the reduction in volume risk associated with Airservices' short-term counter-cyclical pricing policy. In an article written in a World Bank publication, *Price Caps, Rate of Return Regulation, and the Cost of Capital*²³, Alexander and Irwin note that the systematic risk exposure of a firm may depend on the type of regulation that a firm is subject to. The justification for this view is that if prices are adjusted each year to keep the rate of return constant (ie. rate of return regulation) investments in that firm are subject to limited market risk. If a firm is subject to price cap regulation changes in the market will have a larger influence on its revenue stream. Thus firms subject to rate of return regulation tend to have low betas and a lower than average cost of capital.

The self imposed constant rate of return policy of Airservices in the presence of prices surveillance has reduced the volatility of Airservices' revenue in economic upturns while leaving it exposed to economic downturns. In 2002 the Commission was of the view that:

The culminating effect of these two opposing policies upon the asset beta is however difficult to discern leading the Commission to consider the asset beta which would prevail in the absence of a constant rate of return policy²⁴.

The Commission also noted that if the pricing policy of Airservices was maintained then the asset beta would be lower than 0.7. Qantas and BARA also note in submissions that the observed betas for airports reflects a different approach to price setting and risk sharing than the one currently used by Airservices.

BARA argues that an asset beta of 0.46 was appropriate, based on an industry average asset beta for listed infrastructure and utilities companies sourced from the Commission position paper relating to airports, *Government Mandated Security Requirements*. In this position paper the Commission highlighted that the average asset beta for listed infrastructure and utilities companies was an appropriate proxy

²³ Alexander, I. and Irwin, T., "Price Caps, Rate of Return Regulation, and the Cost of Capital", *Viewpoint*, World Bank Group, September 1996, Note No. 87.

²⁴ ACCC (4), *op.cit.*, p43.

where airport operators faced limited systematic risk if pricing reviews and adjustments occurred on a 12 monthly basis. The Commission stated that:

The Commission is of the view that the cost of capital (the required rate of return on capital should reflect the relative certainty of cash flows associated with cost recovery arrangements. In cases where risks to the airport operator appear largely controlled, the Commission sees merit in assigning that project an asset beta which reflects this environment. The Commission regards as a useful benchmark the asset beta for the Australian Stock Exchange Industry Group for Infrastructure and Utilities.²⁵

The reduced uncertainty associated with Airservices' cash-flows resulting from its pricing behaviour (12 monthly pricing proposals) in conjunction with the Commission's view presented in March 2000 indicates that an appropriate industry comparison could be with infrastructure and utilities companies.

The asset beta proposed by BARA was originally sourced from the Australian Graduate School of Management, Risk Measurement Service for the quarter ending March 1998. In December 2001, the Risk Management Service reported that the industry average asset beta for infrastructure and utilities companies was 0.58.²⁶ This approach therefore provides a useful anchor for the range of 0.55 to 0.70 proposed by the Commission in 2002.

The effect of lowering the asset beta to the lower end of the range of 0.55 and 0.70 proposed by the Commission on the weighted average cost of capital and allowable revenue is presented in Table 15.1.

Table 10.1 Alternative Asset Betas

Asset beta	Equity beta	Post-tax nominal return on equity (%)	Nominal Vanilla WACC (%)	Return on Capital for Regulated Assets (\$m)	'Indicative' revenue (\$m)
0.55	0.87	10.0%	8.1%	31.0	528.9
0.57	0.90	10.2%	8.2%	31.5	529.4
0.70	1.12	11.5%	9.0%	34.5	532.4

Table 11.1 shows that a decrease in the asset beta from 0.70 to 0.57 decreases the return on capital, and hence allowable revenue, by approximately \$3.4 million. Alternative values for the regulatory asset base were also modelled in conjunction with the changes in the asset beta. This modelling shows that the dollar return on capital figure is moderately sensitive to possible adjustments to asset values. Varying the valuations of the regulatory asset base, by around 10% changes the return on capital by approximately \$2.5 million. For more information regarding the Commission's asset valuation refer to section 11.

On the basis of the views presented in the BARA and Qantas submissions, the Commission's previous 2002 decision, and the analysis presented above, the Commission is of the view that the appropriate asset beta for Airservices will depend

²⁵ ACCC (3), *op.cit.*, p5.

²⁶ Australian Graduate School of Management Studies, Centre for research in Finance, *Risk Measurement Service*, December 2001.

upon the price setting and risk sharing policy of Airservices. Based on Airservices' current approach, the Commission suggests that the appropriate asset beta for Airservices could be closer to the lower end of the range, 0.55 to 0.75, presented in the Commission's 2002 decision.

10.6 Response to Commission's preliminary view

Airservices states its concerns that, in the absence of observable market based valuations of equity, the application of the building blocks methodology lacks precision. In particular, Airservices claims that as estimations of an asset beta and optimised asset values are prone to less than efficient arbitrated outcomes, the model can only, at best, provide a rudimentary guide as to reasonable revenue levels.

Airservices argues that it has a higher level of systematic risk than relatively low risk airports or "infrastructure and utility" organisations. According to Airservices there are important differences in risk levels facing airports compared to those facing Airservices.

- Aviation revenues, based on variable units of activity, generally account for less than 30% of total revenues at airports. The remainder is primarily property related, which are typically medium to long term fixed lease payments. In contrast, over 90% of Airservices Australia's revenue is based on variable units of activity.
- Airport operating costs amount to less than 30% of revenues, with earnings before interest tax depreciation and amortisation (EBITDA) of around 70%. In contrast, Airservices Australia's operating costs are almost 84% of total revenues, with an EBITDA of around 16%.

According to Airservices, with more stable revenue streams and higher fixed costs, the performance of airport operations is considerably more predictable, with less systematic risk than is the case for Airservices.

Airservices disputes the Commission's Preliminary View assessment that Airservices may have limited its systematic risk exposure through a short term counter cyclical pricing policy that is analogous to constant rate of return regulation. According to Airservices this is an invalid comparison and would be true if Airservices earned the same return each year or set prices to over recover normal returns to make up for past losses. Airservices argues that if this was the case, it would, seek a significantly greater price increase to re-coup the shortfall in profitability in the current financial year.

Airservices claims its returns have varied every year and the balance sheet still contains significant accumulated losses.

According to Airservices the fact that the asset beta is so open to qualitative debate reinforces the concerns over the degree of precision possible in determining an asset beta and consequential claim on revenue outcomes. Notwithstanding the above, Airservices states that building block calculation demonstrates that, even with an asset beta in the range of 0.55 to 0.70, the revenues generated by the proposed 2.7 per cent price increase are well within reasonable bounds.

BARA, while not objecting to the asset beta used by the Commission in its Preliminary View, has identified some concerns about changes in the value of the infrastructure and utilities index over time. In particular it notes that if changes in the value of the index are due mainly to additional more risky infrastructure firms being added to it then the Commission might need to adopt a different approach to determining asset betas for organisations such as Airservices which take on relatively little volume risk.

BARA also disputes claims by Airservices that it has a higher level of systematic risk relative to airports. According to BARA “Airservices clearly does not understand the revenue structure of airports”. BARA argues that the dominant source of revenue growth at airports has been in retail business areas the proceeds from which are directly related to traffic outcomes. In addition BARA claims that airports accept the revenue risk of volume changes through their pricing policies both in their aviation and non-aviation business. In contrast, Airservices’ pricing proposal “is a direct consequence of the fact that Airservices policy is to pass volume risk back to their airline customers”.

Qantas disputes Airservices’ claim that its revenue streams are more volatile than that of major airports such as Brisbane and Melbourne. According to Qantas an examination of the Regulatory Accounts of Phase I and II airports shows that the majority of aeronautical revenues are determined by activity factors including the number of landed tonnes, passengers, aircraft turnarounds and taxi throughput. Non-aeronautical revenues are also largely dependent on activity volumes, as the returns to the airport from concessionaires are often a function of passenger expenditure and throughput.

In addition, when the Commission determined asset betas for necessary new investment (NNI) projects for airports during the recent five-year regulatory period, there were little or no fixed payments associated with the provision of the new services and facilities. Instead, the airport assumed risk on the activity volume, usually landed tonnes or passengers.

Qantas argues that Airservices’ asset beta should remain close to 0.55 for the purposes of this current pricing proposal. Qantas suggests this is consistent with both empirical evidence and previous decisions by the Commission. As part of the longer-term approach to price setting, Qantas argues that a revised asset beta can be negotiated based on the level of risk Airservices is prepared to accept on its investments.

10.7 Commission’s conclusion

The Commission considers that there is a case for Airservices asset beta to be revised downwards given the reduction in volume risk associated with Airservices’ current short-term counter-cyclical pricing policy.

The Commission therefore reaffirms the position identified in its Preliminary View that based on Airservices’ current approach, the appropriate asset beta for Airservices could be closer to the lower end of the range, 0.55 to 0.75, presented in the Commission’s 2002 decision.

In reaching this conclusion the Commission has considered the arguments put forward by Airservices. The Commission recognises that there a number of factors that will impact upon the determination of an appropriate asset beta for Airservices. These factors include:

- the duration of pricing;
- the volatility of earnings; and
- the carry forward of over/under recoveries.

With regard to the arguments raised regarding the variability of revenue received by airport operators. The Commission's understanding is more consistent with the views expressed by BARA and Qantas that airport operators' non-aeronautical revenue streams may be substantially influenced by aviation activity levels.

The Commission, recognises, however, that the determination of an appropriate asset beta to apply to Airservices would need to take all the above factors into account. The Commission encourages Airservices to undertake further analytical work on this matter in consultation with its customers as part of the development of a forward looking longer term pricing framework.

11 Community Service Obligations (CSOs)

11.1 Introduction

A community service obligation can be defined as arising when a government specifically requires a public enterprise to carry out activities which it would not elect to do on a commercial basis and which it does not require other businesses to undertake or which would only be undertaken commercially at higher prices.

Airservices carries out various CSOs under Government direction.

One CSO is the maintenance of a price cap at a number of general aviation and regional airports. In a Minister's Directions and Charter letter dated 25 October 1999²⁷ the Minister noted the importance placed by the Government on small business dependent on air traffic services, particularly in rural and regional Australia. The letter further stated that "under the agreed arrangements, Airservices must consult with the Department before making any significant changes to the services provided at the subsidised locations"²⁸.

In response to this direction, Airservices has capped charges for terminal navigation at general aviation and regional airports at \$7.42/tonne and, as a result, under recovers costs at 16 airports. This under recovery is partly offset by a government subsidy of \$7 million; however Airservices estimates in its pricing proposal that in 2003/04 even with this subsidy it will incur a shortfall of \$10 million.

Within this context the Commission also noted in its 2002 decision that charges for Airservices' commercial activities should not incorporate a cross-subsidy for its CSOs.

11.2 Airservices' initial position

Airservices has agreed that user charges should not be set at a level that requires shortfalls in government funding of CSOs to be cross-subsidised by other users. In its building block analysis, therefore, the shortfall between the identified *direct cost* of the CSO and its *net cost* is subtracted from its calculation of indicative revenue.

11.3 Views of interested parties

Qantas suggest that Airservices appears to have a mixture of CSO funding mechanisms in its submission. The first is \$7m in direct budget funding from the Government ("Direct CSO Funding"). The second component is a reduction in returns to the shareholder of \$10m ("Implicit CSO Funding"). Airservices has therefore estimated its total CSO cost at price capped towers at \$17m in 2003-04.

Qantas notes that Airservices has provided little financial information on how the \$10m shortfall was derived. Qantas further suggests that given the lack of financial data over its estimation, it is appropriate that the Commission undertake its own

²⁷ Airservices Australia (2), *op.cit.*, p77 Appendix 4, pp75-81.

²⁸ *ibid* p77.

costing exercise of Airservices' CSO obligations at price-capped towers. Qantas further argues that the direct costs of CSOs is higher than has been claimed by Airservices and that an amount of \$15 million rather than \$10 million should be assumed for 2003-04 as the level of "implicit CSO funding".

Qantas also notes that it is unclear how Airservices has incorporated "direct CSO funding" in its building blocks calculation. Qantas suggests that it appears that Airservices has not included the \$7m in direct CSO funding to "Total Airways Revenue" or added it to "Less net CSOs" and that, rather than under-recover by \$6.4m, Airservices will over-recover \$0.6m without addressing the other issues raised in the Qantas submission.

BARA notes its understanding that the appropriate figure for the CSO component is \$17 million, not \$10 million as contained in Airservices' proposal. BARA believes that to properly determine whether Airservices is not using its market power to cross subsidise loss making activities, it must provide a detailed analysis of how it has arrived at this figure. BARA supports the view expressed by the Commission that the treatment needs to be resolved by the Government and industry participants.

Virgin Blue argues that Airservices should confirm that the proposed prices increases will not be used by it to effectively subsidise unfunded Community Services Obligations or towards the payment of superannuation liabilities.

IATA welcomes Airservices' decision to seek a reduced level of profitability on account of the shortfall in government subsidies for CSOs at capped tower locations.

11.4 Commission's preliminary analysis and conclusion

The Commission endorses the change in Airservices' approach to the funding of CSOs.

The Commission notes that Airservices' preliminary pricing proposal to the Commission did not reflect the \$7 million in direct funding for CSOs within the building block framework. The Commission also sought additional information from Airservices on the methodology it uses to calculate CSOs and to confirm its estimate of the cost of CSOs in 2003/04.

Airservices has advised the Commission that it underestimated the cost of CSOs in 2003/04 and that the direct cost of CSO provision (excluding corporate overheads) is now estimated to be \$17.9 million which increases the implicit CSO funding from \$10 million to \$10.9 million.

The Commission has incorporated the increase in implicit CSO funding together with the \$7 million in direct funding for CSOs into the building block analysis. The net impact of these adjustments is that - without taking into account other possible modifications to the Airservices analysis - Airservices would over recover revenue by \$2.3 million, not under-recover by \$6.4 million as it suggests.²⁹

²⁹ Other minor adjustments have been made to the analysis re-submitted by Airservices.

11.5 Response to Commission's preliminary view

Qantas claims that confusion over the level of Airservices' CSOs and its incorporation into pricing arrangements highlights the current lack of transparency by Airservices over many financial aspects of its operations

According to Qantas the cost of Airservices' CSO should also be accounted for by Airservices as a *de facto* return to its shareholder. Such an approach would be facilitated by an economic value added assessment (EVA) of financial performance. The EVA approach for Government-owned monopolies accounts for both changes to the asset base of the business and the provision of any services where revenues do not recover costs. An appropriate financial target could be $EVA = 0$ over the medium term.

11.6 Commission's conclusion

The Commission endorses the change in Airservices' approach to the funding of CSOs.

The Commission encourages Airservices to provide further information to its customers on the scope of its CSO activities and the funding for these activities.

12 Activity levels and forecasts

12.1 Airservices' initial position

Airservices states that during 2002/03, activity growth has proved to be well below the forecast accepted by the Commission in its decision last year. Airservices estimates that activity growth for the year will equal 1.7%, or just over half the budget assumption of 2.9% for the financial year. Airservices is concerned that this figure may fall further depending on the impact of the war in Iraq and the SARS virus. Airservices estimates that the 1.2% shortfall in budgeted growth already equates to \$6 million in lost revenue.

Airservices has now developed an updated financial plan for 2003/04, which proposes a 4.2% increase to airways revenue. This planned revenue increase is predicated on a 2.3% weighted average growth in activity for 2003/04. The activity growth rate assumptions adopted for this proposal take some account of the impact of global insecurity but do not include the impact of the SARS virus scare, or the current war in Iraq.

The following table details the growth assumptions for 2003/04 by service line.

Table 13. 2 : Budgeted Activity Growth Rates

	2002/03 Plan	2002/03 Forecast	2003/04 Plan
TN	2.6%	0.2%	3.0%
ARFF	4.0%	0.9%	2.7%
Domestic Enroute	6.2%	6.1%	4.4%
International Enroute	0.5%	0.5%	0.5%
Weighted Average	2.9%	1.7%	2.3%

However, Airservices' original notification advises that if the anticipated effects of the war in Iraq on world aviation are translated into the Australian market, revenue could be negatively impacted by \$19 million in 2002/03 and by between \$16 million and \$44 million in 2003/04³⁰. This modelling has been summarised by Airservices and is provided in the following tables.

³⁰ Airservices advises that assumptions used are broadly consistent with advice received from the airlines, which indicate that a 20% reduction in traffic levels could result for the duration of the war. The range of impacts is based on three scenarios – Short Term conflict (up to 2 months); Medium Term (2 to 4 months) and Long Term (4 to 9 months).

Table 13.2: Potential Revenue Impact of Iraq Conflict

2002/03			
	Short (up to 2 months)	Medium (2 - 4 months)	Long (4 - 9 months)
Domestic Enroute	4.8%	4.8%	4.8%
International Enroute	-4.3%	-4.5%	-4.5%
Terminal Navigation	-3.5%	-3.6%	-3.6%
ARFF	-2.2%	-2.2%	-2.2%
Weighted Average	-2.1%	-2.2%	-2.2%
REVENUE IMPACT	-\$19.0m	-\$19.5m	-\$19.5m

2003/04			
Domestic Enroute	4.5%	3.6%	2.6%
International Enroute	1.0%	-2.7%	-6.7%
Terminal Navigation	3.7%	1.2%	-1.5%
ARFF	2.0%	-0.6%	-3.1%
Weighted Average	2.7%	0.1%	-2.8%
REVENUE IMPACT	-\$16.1m	-\$29.9m	-\$44.1m

Airservices states that its preferred approach to dealing with this potential financial loss would be to first identify and implement cost reduction initiatives. However, Airservices does state that it may be left with no choice but to “make a supplementary pricing submission, aimed at making up the shortfall in revenue through higher prices, as targets have already been substantially reduced”³¹.

12.2 Views of interested parties

12.2.1 International Air Transport Association (IATA)

IATA acknowledges that the international market currently appears very depressed and notes that there still exist a number of unknowns that could result in significant change.

IATA recognises the impact the events of September 11, 2001, the Bali bombings, SARS and the war in Iraq have had, and continue to have on aviation. Furthermore, IATA points to current reports that indicate that Asian carriers have cut around 650 weekly flights in April, and that while the war in Iraq appears to be coming to an end, the duration and full extent of the SARS crisis is not yet known.

Notwithstanding this analysis, IATA states that these contractions in traffic volumes are abnormal and should not be a reason for Airservices to increase prices. IATA states that it is “not acceptable that prices would be increased so that near normal year returns could be provided to shareholders”³².

³¹ Airservices Australia (1), *op.cit.*, p16.

³² IATA submission, p3.

12.2.2 Board of Airlines Representative of Australia (BARA)

BARA is concerned that Airservices has not paid heed to comments made by the Commission in its final decision document last year. In that document, the Commission concluded that a review of traffic volumes should be undertaken prior to any increase in charges beyond 2002-03. BARA believes that the Commission should object to Airservices' proposal and direct Airservices to provide a notification that specifically addresses issues identified by the Commission in its 2002 decision, including issues pertaining to activity levels.

BARA's submission also comments that it is disappointed Airservices has provided no public information pertaining to expected traffic volumes, either in aggregate or at individual locations. It is BARA's view that airports are required to provide a greater depth of public information and that the Commission ought to require the same level of disclosure from Airservices.

Finally, BARA is concerned that, in the absence of long term forecasts, it is not able to determine if the global insecurity described by Airservices is modelled as a short-term factor, or as a long-term structural change. Furthermore, BARA is concerned that it is not able to determine the effect global insecurity might have on domestic traffic.

12.2.3 Qantas

In its draft notification, Airservices comments that it will only realise a 1.7% growth rate for 2002/03, despite forecasting a growth rate of 2.9%. Qantas comments that this initial forecast figure was made in May 2002 and therefore would likely not have taken account of the future effects of a war in Iraq, or the ramifications of SARS. As a result, Qantas believes that an activity growth rate of 1.7% in fact suggests "a more resilient market exists than Airservices would have us believe"³³.

In addition, while Qantas agrees that Airservices has a pattern on reducing prices in times of increased activity, Qantas believes that "the inherent faults of this approach to price setting compared to longer-term price paths is now obvious"³⁴. Qantas goes on to state that at a time where many airlines are feeling financial strain, it believes Airservices is justifying a price increase on the basis that "when other organisations were purportedly making money, AsA (Airservices) did not earn as large a profit as possible"³⁵.

12.2.4 Gold Coast Airport

Gold Coast Airport's (GCAL) submission addresses traffic volumes at that airport only. GCAL submits that while landed tonnes for 2001/02 were 610,890, its conservative estimate of landed tonnes for 2002/03 is 720,000, a nearly 18% increase on 2001/02. As this is higher than the 2.9% assumed in Airservices' notification last year, GCAL states that it "sees no reason for not reversing Gold Coast TN charges

³³ Qantas submission, p8.

³⁴ *ibid*

³⁵ *ibid*

back to a figure somewhere below the \$9.09 foreshadowed in AsA's (Airservices') submission dated 1 July 2002³⁶.

12.2.5 Queensland Government

The Queensland government submission acknowledges comments made by IATA indicating that the airline industry is currently experiencing significant financial stress. The submission goes on to state that in the 20 week period between 17 April and 3 September 2003, Queensland is expected to lose 160 scheduled international inbound airline services. Assuming a 75% load factor, the Queensland government has estimated a potential loss of almost 28,720 visitors. Domestic on carriage is also expected to decline as a consequence of a fall in international air travel demand, although the Queensland government expects some substitution in favour of domestic travel.

12.2.6 Regional Aviation Association of Australia (RAAA)

RAAA's submission suggests that the aviation industry as a whole, and in particular the regional sector, is currently struggling to remain viable, as a result of a downturn in passenger numbers. RAAA believes that global conflict, the threat of terrorism, increased government taxes and charges and SARS are responsible for this downturn.

However RAAA does not believe that, in the face of such traffic constriction, Airservices should increase charges levied on airlines. RAAA goes on to say that:

It is unacceptable that a monopoly provider increases costs to ensure profitability, when the very reason for the downturn in its profitability is the downturn in profitability of the industry it services³⁷.

12.2.7 Mackay Airport

Administered by the Mackay Port Authority, Mackay Airport has addressed the appropriateness of lower volumes as a case for increased prices. Mackay Airport states that in response to the events of September 11, it adopted a long term approach to pricing and forgoed its return on investment for 18 months, rather than increase prices. Mackay Airport does not think it appropriate for Airservices to increase prices in order to "retain revenue"³⁸.

12.2.8 Virgin Blue

Virgin Blue is concerned that Airservices' forecasts have made no distinction between domestic and international traffic and has therefore assumed that "international developments such as the war in Iraq and the SARS epidemic will affect domestic aviation in much the same way as it affects the international aviation market"³⁹.

³⁶ Gold Coast Airport submission, 28 April 2003, p2.

³⁷ RAAA submission, 28 April 2003, p3.

³⁸ Mackay Airport submission, 28 April 2003, p7.

³⁹ Virgin Blue submission, 9 May 2003, p6.

Virgin Blue does not believe that this is the case and suggests that while most international carriers are struggling financially and have reduced capacity on international routes, this has not necessarily been the case for domestic carriers which are less susceptible to customer concerns about such events.

Virgin Blue's submission goes on to say that it, and to the best of its knowledge, Qantas, has not reduced capacity on any major domestic routes in the 2002-03 financial year.

On this basis, Virgin Blue believes that TN and ARFF charges should not apply to domestic carriers and that Airservices should provide information pertaining to traffic volumes at individual airports.

12.3 Commission's preliminary analysis and conclusion

In reaching its final decision last year, the Commission acknowledged concerns raised by airlines that Airservices' forecasts may have been conservative. However, the Commission noted that the aviation market was volatile at the time and therefore agreed to a price increase for a period of 12 months.

In reaching that decision, the Commission noted that it would be reluctant to consider any further price notifications in the absence of thoroughly substantiated traffic volumes and forecasts.

However, submissions received by the Commission criticise the lack of information provided by Airservices in its current notification. For example, in its submission, BARA suggests that the Commission should reject Airservices' draft notification, and request that a review of traffic volumes be undertaken prior to further price notifications. Similarly, Virgin Blue is concerned that Airservices has not provided a breakdown of international and domestic volume forecasts, nor traffic volumes for individual airports. In its response to submissions, however, Airservices states that it has in fact consulted widely with customers and peak industry bodies on the issues of traffic volumes, the basis of future growth and the risks associated with the war in Iraq and SARS.

Notwithstanding criticism on the lack of information provided, the Commission has received few submissions objecting to Airservices' overall traffic volume forecasts for 2003/04. For example, IATA, RAAA and the Queensland government agree that the international travel market does appear very depressed at the moment and Qantas acknowledges that the long-term impacts of September 11, 2001, the Bali bombings, SARS and the war in Iraq have led to a global downturn in bookings. However, BARA is concerned that no location specific activity forecasts have been made public by Airservices.

The Commission notes that Airservices' 2003/04 forecasts may not fully take into account the potential impact of the war in Iraq or the effect of the SARS virus on air travel. The Commission acknowledges that it is quite possible these factors may serve to further depress the aviation market.

The Commission also recognises that Airservices' forecasts for 2002/03 were proven to be too conservative, with real growth for 2002/03 only expected to reach 1.7% despite being forecast at 2.9%. However the Commission notes that this difference may have been the result of unforeseen events and also acknowledges comments made by Qantas in its submission. Qantas suggests that the forecast growth rate of 1.7% for 2002/03 may in fact, when taking into account the war in Iraq and SARS, indicate a more resilient than expected aviation market. Finally, the Commission also recognises comments made by the Gold Coast Airport. Whilst only relating to activity levels at the airport, GCAL's submission states that expected activity growth at the airport is expected to be approximately 18% this year and therefore does not believe any increase in TN charges at the airport is justified.

However, given the current level of volatility, a lack of opposition to Airservices 2003/04 forecast activity levels, and the fact that Airservices forecast for 2002/03 did understate activity levels, the Commission's preliminary view is to recognise Airservices forecast growth rate of 2.3% for 2003/04 as being appropriate.

12.4 Response to Commission's preliminary view

BARA does not object to the traffic growth forecasts assumed by Airservices in its pricing proposal and accepted by the Commission.

According to Qantas an integral part of developing a longer-term approach to pricing will be the provision of forecast activity data by Airservices disaggregated by services provided. Qantas also notes that as Australian airports have been able to produce ten-year traffic forecasts such a requirement would not seem unreasonable for Airservices.

In its response Airservices has provided revised activity forecasts for 2002/03 and 2003/04.

The new forecasts by service are summarised in the following table.

		Previous Submission			Revised		
		2002/03	2003/04	Growth	2002/03	2003/04	Growth
International Enroute	Sqrt t / 100km	37,516,447	37,685,271	0.5%	36,988,680	36,970,500	0.0%
Domestic Enroute	Sqrt t / 100km	27,310,128	28,498,391	4.4%	27,064,159	27,707,338	2.4%
Terminal Navigation	tonnes	34,653,435	35,693,038	3.0%	33,948,397	34,364,441	1.2%
Aviation Rescue & Firefighting	tonnes	33,514,562	34,419,455	2.7%	32,758,816	33,114,925	1.1%
Weighted Average				2.3%			1.1%

- Overall traffic growth in 2003/04 is now assumed to be 1.1% compared to the previous estimate of 2.3%.
- International en route activity in 2003/04 is now forecast to remain at the same overall level as 2002/03. The forecast for 2003/04, assumes the maximum impact of SARS will be factored in within the next 2 months, after which a relatively rapid recovery path in the second and third quarters of 2003/04 will see activity in the fourth quarter rise above the levels experienced immediately before the outbreak of war and SARS.

- Domestic en route activity in 2003/04 is now forecast to be 2.4% higher than 2002/03 levels. According to Airservices this reflects the Virgin Blue and Qantas fleet expansions followed by the transfer of domestic aircraft to Australian Airlines' international operations.
- Airservices expects TN and ARFF activity in 2002/03 to follow the en route trends resulting in 1.2% growth for TN and 1.1% for ARFF.

12.5 Commission's conclusion

The Commission notes that Airservices has revised its activity forecasts downwards and now only expects an overall 1.1% growth rate in 2003/04 compared to the 2.3% growth rate identified in its draft pricing proposal.

The Commission accepts Airservices revised growth forecasts but notes its short term focus. The Commission, considers however, that when developing a long term price path for Airservices the focus should be on longer term trends rather than year to year forecasts. Within this context the Commission notes that Airservices current estimated 2003/04 growth rate is below its recent average annual growth rate. This is not an unexpected result given that activity levels for the 2003/04 financial year have been adversely affected as result of the SARS virus and levels of international uncertainty that have affected aviation markets globally.

The Commission would encourage Airservices to support its forecasts with reference to some independent long term forecasts of activity levels which could then be used as part of a platform in the development of a long term pricing path with its customers.

13 Structure of Pricing

13.1 Introduction

In the context of the assessment of Airservices proposal, the Commission may consider not only the overall proposed price increase in relation to cost and efficiency but also the impact of the pricing proposal on the structure of relative prices. Price relativities may have an impact on the overall efficiency of Airservices operations. The relationship between the drivers of cost and prices can be a relevant aspect in assessing the efficiency of Airservices operations, as it may impact on the resource allocation decisions by both Airservices and its users.

13.2 Airservices' initial Position

Airservices is proposing a 6.95% increase to prices at uncapped Terminal Navigation and Aviation and Rescue fire-fighting (ARFF) ports, with a small number of exceptions⁴⁰, from 1 July 2003. Airservices does not propose to increase the price of en-route navigation. The increases are proposed as temporary, applying for a 12-month period until 30 June 2004.

Airservices moved to location specific pricing from network pricing in 1997/98. This change was designed to improve the efficiency of its price structure as prices would better reflect the cost of providing TN and ARFF services. In its 2003/04 pricing proposal Airservices states that:

Airservices Australia's pricing approach was further refined by establishing firm prices for each service at each location at the start of each year, based on activity levels and prospective cost reductions, and accepting the risk that these outcomes may not be achieved.⁴¹

From 1 July 1998 Airservices implemented the first stage of a planned three stage process of location specific pricing for terminal navigation at the 26 airports. From 1 July 1997 location specific pricing was also introduced for aviation rescue and fire fighting services at 16 locations. The basis for the location specific price structure of TN and ARFF services is aircraft weight per 1000kg MTOW.

In regard to the Terminal navigation in (mainly) rural and remote areas Airservices has capped charges at 7.42/tonne and claims that, as a consequence, it under recovers costs for terminal navigation services and tower services at 16 airports which cater for general aviation. This under recovery is partly offset by CSO funding.

Airservices is of the view that the proposed increase in charges does not fully recover the costs of its community service obligations and that at the higher proposed price levels losses on TN and ARFF services would still occur at most locations. It further highlights that en route services are clearly making up for the shortfall on the TN and ARFF service lines.

⁴⁰ The exceptions are charges for TN at Hamilton Island, which are proposed to increase by 38%, and ARFF charges at Mackay and Rockhampton airports, with proposed increases of 59% and 46% respectively.

⁴¹ Airservices (1), *op.cit.*, p7.

13.3 Views of Interested Parties

A number of submissions raise similar issues regarding Airservices' pricing structure. These include:

- the application of the same average increase in prices for TN and ARFFs at almost all airports; and
- the weight based charging methodology.

13.3.1 Qantas

The average price increase to TN and ARFF services was an issue that Qantas raises in its submission. It notes that:

It is unclear if the average price increase of 6.95% applied to TN and ARFFS (except Mackay and Rockhampton) across non price capped airports is consistent with the policy of location specific prices for services at these airports⁴².

A second issue Qantas raises in its submission is in regard to the weight basis of TN and ARFF charges. Qantas notes that:

While weight may have been a relative proxy for air traffic charges some four decades ago in the pre-jumbo era, the subsequent growth in aircraft size and weight has been a no cost windfall growth in income to air traffic management providers. This means that while air traffic proclaim to have reduced prices from efficiencies a large proportion is actually attributable to increases in the average weight of aircraft.⁴³

In its submission Qantas concludes that Airservices' pricing structure does not reflect costs and does not encourage efficient use of air traffic resources.

13.3.2 BARA

BARA is of the view that the proposal by Airservices to increase charges by a uniform percentage rate across all locations is counter to the principle of location specific pricing.

13.3.3 IATA

IATA in its submission to the Commission comments on the price structure for services provided by Airservices. In particular, IATA raises the following issues: the across the board increase in prices proposed by Airservices, and the basis of charging for TN services. Regarding the across the board increase in charges at uncapped airports for TN and ARFF services IATA also notes:

For such an increase to be reasonable, the level of under recovery of costs at all these airports should be similar, if we are to assume that location specific charges are being applied in an equitable manner.⁴⁴

⁴² Qantas submission, p12.

⁴³ *ibid*

⁴⁴ IATA submission, April 2003, p4.

13.3.4 Mackay Airport

In its submission to the Commission, Mackay Airport, administered by the Mackay Port Authority, has highlighted two areas of concern in regard to Airservices price structure. These issues are:

- that the extent of cross subsidisation between terminal navigation, ARFF and en-route services is unknown; and
- uniform percentage increases based on location specific pricing instead of network pricing.

13.3.5 Gold Coast Airport

In relation to Airservices' proposal GCAL has reiterated many of the concerns that have been mentioned above, the location specific pricing on weight basis and the uniform proposed price increase. The GCAL submission notes that:

GCAL cannot understand AsA's pricing structure and methodology in the case of site specific charges for Gold Coast Airport⁴⁵.

GCAL also notes that the uniform price increase is sought despite a commitment by Airservices to reduce TN charges in 2003/04 back to \$9.09. This is despite actual activity growth at the Gold Coast of 18%, approximately 15% above Airservices budgeted growth⁴⁶. In its submission GCAL concludes by questioning the 'rigour of site specific pricing when all major airports are to subjected to uniform price rises of 6.95% for both ATC and RFFS'.

13.3.6 Regional Aviation Association of Australia

In its submission, RAAA notes the importance of Airservices' price structure reflecting the costs of providing services and on that basis recommends that Airservices investigate the option of User Specific Charges, instead of location specific charging.⁴⁷

13.3.7 HeliAust Whitsundays Pty Ltd (HeliAust)

In its submission HeliAust claims that Airservices' proposed price increase is not justified on basis of the cost of providing these services. It states that:

- the fees proposed do not represent a valid charge for the service provided; and
- by Airservices own admission the tower at Hamilton Island is not justified on either safety or cost basis.⁴⁸

⁴⁵ Gold Coast Airport submission, April 2003, p2.

⁴⁶ *ibid* p2.

⁴⁷ Regional Aviation Association of Australia submission, April 2003.

⁴⁸ HeliAust Whitsundays Pty Ltd (HeliAust) submission, May 2003, p1.

13.3.8 Virgin Blue

Virgin Blue notes in its first submission that the proposed price increases by Airservices will in its view ‘reward inefficiency’ as Airservices has not provided enough detail on the relationship between its underlying costs and its proposed new price levels.

In its second more detailed submission to the Commission, Virgin Blue notes that the proposed price increase by Airservices is not reflective of the cost of providing TN and ARFF services at different locations and is inconsistent with the principle of location specific pricing. In its submission Virgin Blue states that:

ASA has not provided any evidence in its preliminary pricing proposal about the extent to which costs for the provision of TN and ARFF services have increased at particular airports. Virgin Blue does not believe that the proposed 6.95 per cent increase in TN and ARFF charges at 12 airports is cost reflective, as the cost of providing TN and ARFF services is typically airport specific and therefore is likely to vary between airports, depending on specific factors such as traffic volumes.⁴⁹

Virgin Blue also notes in its submission that the current short term pricing policy does not provide sufficient incentive for future efficiency improvements⁵⁰.

13.3.9 Airservices’ response to submissions

Airservices claims in its response to submissions that the current pricing structure reflects its commitment to continued efficiency improvement. It also notes that:

The reason for the apparent uniformity of the increase is that the magnitude of the increase delivered the overall targeted return and was able to be applied to all locations without any one port achieving a greater than appropriate return.⁵¹

In response to this issue Airservices is of the view that it endeavours to better align prices with costs and points to the shift from network pricing to location specific pricing for TN in 1997/98. In its response Airservices also signals its intention to implement a review of charges for enroute services in order that these charges better reflect service levels and cost.

13.4 Commission’s preliminary analysis and conclusion

A number of submissions have raised concerns about price structural effects surrounding Airservices’ proposed price increases. The issues raised seem to apply at several levels, including:

- relativities between en-route charges, TN charges and ARFF charges;
- relativities between TN and ARFF charges at different locations; and
- relativities between different users at particular locations.

⁴⁹ Virgin Blue submission, May 2003, p5.

⁵⁰ *ibid*, p4.

⁵¹ Airservices Australia (3), *op.cit.*, p4.

A related issue raised by some parties is the *basis* of pricing, in particular whether charges for TN and ARFF services should be appropriately levied on a weight basis.

On the first point, Airservices argues that even with its proposed increases, it will continue to make a loss on TN and ARFF services. Evidence it has provided supports this claim, and shows that TN and ARFF services appear to be generally operating at a loss, while en-route is making relatively high returns. While it should be noted it does not adopt the Commission's preferred measure of return, the following table shows Airservices' estimate of forecast earnings before interest and tax as percentage of total indicative revenue of the Airservices service lines – en-route, ARFF, and TN from all locations.⁵²

Table 13.1 Service line profitability – 2003/04

	EBIT/revenue %
Terminal Navigation	-2.9 %
ARFF	-8.2 %
En-route	16.4 %
Regulated Business	6.7 %

In this respect, Airservices' decision to not seek increases for en-route charges is appropriate.

In relation to the second kind of relativity – that between TN and ARFF charges at different locations – Gold Coast Airport is of the view that 'there seems to be little correlation between charges levied, the services required and the operating environment at a specific airport'⁵³. GCAL further notes the lack of correlation between demand and prices. Other submissions, from the RAAA and Mackay Airport, also note the apparent lack of connection between demand at particular airports and the prices charged by Airservices for TN and ARFF services. Against that, Airservices suggests in its proposal that the shift to location specific pricing from network specific pricing has improved the efficiency of its operations.

In relation to this issue the profitability considerations outlined above apply. Airservices has provided the Commission with confidential information on costs at specific airports for both TN and ARFF services, which shows that even with the proposed price increases, most locations would continue to operate at a loss in 2003/04. The decision to seek essentially uniform increases (6.95%) therefore seems reasonable.

The Commission notes, however, that many of the concerns expressed by users appear to arise as a consequence of a lack of transparency regarding the costs associated with providing TN and ARFF services at particular locations. Were Airservices to provide relevant parties with more detailed information on these matters it is possible that the concerns may subside.

⁵² These estimates are based on the prices proposed in the current notification, and are sourced from presentations by Airservices at Waypoint 2003. The presentations are available from Airservices' website.

⁵³ Gold Coast Airport submission, April 2003, p1.

In relation to the third issue regarding relativities between prices charged to different users at a particular location, Qantas notes that the use of larger aircraft is penalised as a result of Airservices charging on a tonnage basis. This claim appears to relate particularly to charges for TN services. GCAL suggests that an alternative basis for ARFF and TN charging could be on a per passenger basis since this may better align prices to the drivers of cost of providing services.

13.5 Response to Commission's preliminary view

Qantas welcomes the Commission's recommendation that Airservices consider alternatives to its current charging structure. Qantas also reiterates its concerns about the use of tonnage based charging.

Qantas recommends a review of all of Airservices' charging structure is warranted as part of the development of a longer-term approach to price setting. Such a review should include:

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

According to Qantas industry could agree on a revised charging structure for prices going forward on the basis of such criteria,. Such change would further increase the efficiency by which Airservices provides its services to the industry. Difficult issues such as pricing of GA, regional and intra-state services could be addressed through options such as 'ring-fencing' of charges, as currently occurs at some major airports.

GCAL, while stating that it is encouraged by the Commission's Preliminary View to object to the price increases, considers there is further scope to reverse previously approved temporary price rises. GCAL argues that temporary price rises justified to the Commission on 23 July 2002 were ostensibly to cover the loss of revenue due to the collapse of Ansett and lower traffic volumes following the terrorist attack of 11 September 2001. GCAL argues that as growth at Gold Coast has subsequently increased well in excess of Airservices' assumed growth rate of 2.9%, Gold Coast - specific TN and ARFF charges should be returned to their 2001/02 levels.

GCAL also argues that Airservices' charges are not a true reflection of the cost of providing service at a specific airport location. GCAL claims it can see no reason why charges at Gold Coast should be higher than charges at other airports that have more complex air navigation facilities for essentially the same level of traffic. GCAL is also concerned that there is an arbitrary allocation of costs for approach control services provided to Gold Coast Airport from the Brisbane based control centre and

notes that the adjacent Sunshine Coast/Maroochydore Airport does not require such services despite its similar operating environment.

Virgin Blue states that it does not agree that uniform pricing is appropriate if there are locational cost differences in providing the ARFF and TN services.

Virgin Blue also argues that the levying of charges on a per passenger basis in relation to ARFF and TN services will increase Airservices' inefficiency and would not reflect the cost of providing such services. Virgin Blue claims that the adoption of a per passenger pricing methodology would penalise an efficient, low cost carrier such as Virgin Blue, which carries more passengers per aircraft than less efficient carriers such as Qantas. Virgin Blue argues that the Commission in its final decision recommend that Airservices should not levy ARFF and TN charges on a per passenger basis.

Virgin Blue also states its concerns that "a number of participants in the aviation sector in Australia are using every opportunity that arises in order to try to convert fixed costs (including costs that are fixed on a per flight basis) to variable costs such as per passenger charges". Virgin Blue claims that converting fixed costs to variable costs adds to the cost of offering marginal additional seats on flights and discourages airlines from offering marginal seats at discounted prices. It also rewards inefficiency and removes the competitive advantage of low fare providers.

Mackay Airport states that Airservices operates a monopoly service without competition, yet will not openly share the detailed bases for their charges with their customers.

Mackay Airport argues that as Rockhampton, Launceston and Mackay are to all have level 6 Fire Services and similar hours of operation, no equitable basis was provided by Airservices to justify a proposed Mackay charge of \$15.86/t, 59% above Launceston and 13% higher than Rockhampton. Mackay Airport acknowledges that Airservices subsequently reduced the proposed charge to \$14.91/t. According to Mackay Airport however, this would still generate annual revenue to Airservices in Mackay of some \$2.5m, 38% higher than either Rockhampton or Launceston "for effectively the same service".

According to Mackay Airport the proposed charge should not be more than \$10.78.

13.6 Commission's conclusion

The Commission remains of the view that there may be scope for some improvement in Airservices' price structure - in particular to better align prices faced by users at particular locations to the drivers of Airservices' costs.

The Commission notes that there are major differences of opinion between Airservices customers on how Airservices should structure its prices, particularly in relation to the use of tonnage and passenger based charges. These issues cannot, however, be resolved in the Commission's current assessment process.

Notwithstanding the above, the Commission encourages Airservices to consider alternatives to its current structure. Airservices is also encouraged to provide relevant

parties with a greater level of detail on the costs of providing services at particular locations.

While noting Virgin Blue's and GCAL's concerns the Commission is still of the view that the proposal by Airservices to seek a near-uniform increase to charges across different locations would be a broadly appropriate approach to increasing revenues.

The Commission further notes that within a long-term pricing proposal, there should be flexibility for Airservices to re-structure prices over time. Such re-structures have been accommodated with other businesses subject to prices surveillance; for example, airports and Australia Post.

14 Impact on Users

The Commission's Issues Paper sought views on the impact of the proposed price increases on the demand for air travel, airline scheduling decisions, providers of other aviation services, and airfares.

14.1 Airservices' Position

Airservices has provided estimates of the cost per passenger of the proposed price increases, on a return trip basis, for the top 25 city pairs. It is Airservices' contention that the price increases are unlikely to affect demand.

Airservices estimates that for domestic routes, the largest increase to passengers' airfares will be \$1.46 on the Sydney/Perth route (B747). For international routes, the greatest increase will be \$0.94 on Perth/Singapore (B747) flights. In percentage terms (based on low fare tickets) the largest increase for domestic routes is 0.4% for both Brisbane/Sydney flights (B767-300) and Coolangatta/Sydney flights (B737-300). For international flights, the largest percentage increase, based on a low fare ticket, is 0.1% for both Auckland/Sydney routes (B747-400 and B767-300) and Singapore/Perth routes (B747-400 and B767-300).

14.2 Views of Interested Parties

14.2.1 BARA

In its submission, BARA refers to comments made by the Commission when assessing Airservices' price notification last year. In its 2002 final decision, the Commission stated that the impact of an increase in Airservices' prices on international airlines would only serve to amplify losses arising from a decline in demand.

It is BARA's contention that the situation that led to the Commission forming this view in 2002 has since deteriorated markedly, and that the impact on international carriers of any further price increases will be greater than "that which was previously of concern to the ACCC in 2002"⁵⁴.

BARA goes on to say that:

In an environment where global equity returns are significantly negative, AsA (Airservices) is seeking a price increase to maintain double-digit equity returns to its shareholder. This is in stark contrast to the AsA claim that profit maximisation is not its primary goal⁵⁵.

In concluding, BARA states that Airservices' pricing proposal is contrary to its statutory purpose of "promoting and fostering civil aviation in Australia" and is evidence of why a long-term pricing approach is important.

⁵⁴ BARA submission, 28 April 2003, p6.

⁵⁵ *ibid.*, p9.

14.2.2 IATA

IATA believes that while the contraction of the travel market has affected the travel industry, airports, and air navigation service providers, it has most affected the airlines.

IATA is concerned that international airlines are suffering from reduced passenger loads, and that by applying charges on an airplane weight basis, Airservices is adding further pressure to the financial position of airlines.

Furthermore, following the war in Iraq and the advent of SARS, IATA reports that airlines are “poised to register their 3rd consecutive year of significant losses”⁵⁶. IATA states that preliminary estimates for 2003 suggest a loss of around US \$10 billion. As a result, IATA does not believe that airlines can absorb any further increases in “external costs”⁵⁷. IATA concludes that airlines are in urgent need of assistance to reduce costs so that they can address cash-flow issues.

14.2.3 Gold Coast Airport (GCAL)

GCAL comments that it has been made aware by current and potential airline users of the airport, that changing differentials between the major capital city airports and the larger regional airports are a factor considered by users when investigating new route development initiatives. GCAL believes that this is especially true for the Gold Coast, where there are a “predominance of lower yielding inbound leisure traffic and true competition from Brisbane Airport and some smaller regional airports with no AsA (Airservices) services or charges”⁵⁸.

GCAL states that it has worked closely with a number of government agencies but has difficulties with Airservices. It is GCAL’s contention that TN and ARFF services at GCAL could be operated more efficiently “if there was an incentive for AsA to work with the airport in a co-operative partnership similar to that developed with other agencies and contractors”⁵⁹. GCAL believes that the situation is unlikely to change in the absence of competition within these services.

14.2.4 Mackay Airport

Mackay Airport cites an independent report produced by Access Economics for the Regional Aviation Taskforce that states “(A) review of Government Airservices Australia charges at regional airports are often substantially higher than charges levied for the same services at the primary gateway airports and the charges levied directly by the airport operators themselves”⁶⁰. Mackay Airport states that the report goes on to say that the current charging regime makes regional gateway costs “very unattractive to new airlines and in most cases the cost differential compared with

⁵⁶ IATA submission, 23 April 2003, p4.

⁵⁷ *ibid*

⁵⁸ Gold Coast Airport Ltd submission, 28 April 2003, p3.

⁵⁹ *ibid*

⁶⁰ Mackay Airport submission, 28 April 2003, p8.

primary airports wipes out any benefits of market development incentives offered to airlines by airport operators themselves”⁶¹.

Mackay Airport is concerned by the increasing percentage of airfares going to addressing costs other than those associated with transport from “A to B”. Mackay is concerned that additional costs that flow through to a passenger’s airfare are of grave concern, as they risk suppressing the market rather than growing it.

Mackay Airport also suggests that Airservices has previously implied that airlines should be able to absorb any increased prices, without passing it on to passengers. Mackay Airport believes that this view is “clearly one taken by a monopolistic service provider, and misrepresents the impact on regional services”⁶².

Mackay Airport states that the current ARFF price for passengers using Mackay airport is \$4.32 or 3.9% of the lowest fare available to Brisbane from Mackay (\$110 with Virgin Blue). Mackay Airport suggests that the increase of 59% in ARFF charges will mean that the cost per passenger will increase to \$6.67 a passenger, or 6.1% of the lowest fare. Mackay comments that this increase varies from the information supplied by Airservices in its draft notification, which states a lowest increase of \$0.43 for a return trip between Sydney and Melbourne, a similar distance to Mackay. Mackay Airport is disappointed that Airservices has not included any information on the increase in prices for passengers on smaller routes. Mackay Airport believes that this “displays a narrow view of the effect of increases on the industry, especially regional Australia”⁶³.

14.2.5 Qantas

Qantas estimates that the cost increase it will experience from Airservices’ proposal is likely to be in the order of \$8 million for 2003/04. At the same time, Qantas comments that domestic security issues and associated Government-mandated security requirements will increase overall costs, with Qantas expecting the total cost of enhancing security arrangements to run into the hundreds of millions of dollars over the next few years. Qantas is concerned that this will place further pressure on ticket prices for passengers and returns earned by airlines. Qantas notes that the industry is suffering a global downturn due to the long-term impacts of worldwide economic slowdown, the still present effects of September 2001, the Bali bombings and more recently, the war in Iraq and SARS.

Qantas states that in the current economic climate, further cost increases by suppliers of aviation services will translate into reduced job security for airline workers. Qantas believes that this demonstrates the “inherent problems associated with short-term pricing strategies aimed at fixing a given level of profit each to year to monopoly suppliers”⁶⁴.

⁶¹ *ibid*

⁶² *ibid*, p9.

⁶³ *ibid*

⁶⁴ Qantas submission, April 2003, p15.

14.2.6 Virgin Blue

Virgin Blue believes that the proposed price increases will have a significantly negative impact on users. In its submission, Virgin Blue states that costs for en route, terminal navigation and aviation rescue and firefighting are unavoidable costs and must not be viewed in isolation from other costs associated with operating an airline.

Virgin Blue suggests that the financial burden of increased TN and ARFF charges is likely to be greater for it than for Qantas. This is because, as a full-service carrier, Virgin Blue believes Qantas carries a higher proportion of price insensitive customers (such as business travellers,) and that Qantas is therefore in a better position to pass on price increases without losing customers.

Virgin Blue's submission concludes that the airline is not able to absorb increases as proposed by Airservices and that these increases must be passed on to consumers in the form of higher fares. Virgin Blue is concerned that this will reduce demand and undermine the airline's profitability.

Virgin Blue is also disappointed that Airservices has not provided information pertaining to the breakdown of international and domestic airline activity. A summary of Virgin Blue's comments on this issue can be found in Section 13.

14.2.7 Regional Aviation Association of Australia (RAAA)

The RAAA argues that it is unacceptable that a monopoly provider increases costs to ensure profitability, when the very reason for the downturn in its profitability is the downturn in profitability of the industry it services. The RAAA also notes that the regional aviation sector is struggling to remain viable.

14.2.8 Queensland Government

The Queensland government submission makes the point that the aviation and tourism industries are currently experiencing a downturn in demand. The Queensland government then goes on to state that "any increase in the cost of operations for the airline industry is likely to have a significant and adverse flow on effect for air services operating to numerous regional and rural areas where "the route economics of air services are at best marginal"⁶⁵.

The submission comments that regional centres are disadvantaged in terms of route profitability and that airline decisions regarding further expansion or contraction of services to these destinations is often determined at the marginal level. The Queensland government is concerned that any increase in Airservices' prices will raise airlines' marginal costs and that any reduction or suspension of services is likely to be accelerated as a response to these new charges. This may place at risk opportunities for further growth and development of new services to such rural destinations.

⁶⁵ Queensland Government submission, 6 May 2003, p2.

14.2.9 HeliAust Whitsundays Pty Ltd (HeliAust)

HeliAust's submission is concerned with the effect any increase in terminal navigation charges will have on Hamilton and Mackay airports. An operator of small aircraft and helicopters, HeliAust operates numerous flights of short duration. HeliAust is concerned that Airservices have not taken into account short sector flights, but instead applied the same charge as would be applied to flights of longer duration. HeliAust explains that these short flights generate modest income and therefore HeliAust states that "given the nature of these short sectors any increase in airservices fees will result in the withdrawal of these services, as they move from marginal to loss making".⁶⁶

14.3 Discussion

The requirement to consider the impact on users is in part derived from section 17(3)(a) of the PS Act, which requires that the Commission have regard to the need to maintain investment and employment. Supporting this, the Commission's *Draft Statement of Regulatory Approach to Price Notifications* states that information from users is important in understanding issues and indicates that the Commission will consult with users as part of the assessment process.

In its final decision to Airservices' 2002/03 notification, the Commission recognised that it is possible to divide users into two groups – direct users such as airlines, and end users, such as passengers. The Commission acknowledged that changes in demand and supply conditions affect the financial performance of airlines and ultimately influence investment and employment in the airline industry. This may then affect services to consumers.

In assessing that notification, the Commission discussed the impact that the proposed price increases might have on both direct and end users, and drew a further distinction between international and domestic airlines. While the Commission does not intend to repeat this assessment in response to Airservices' current notification, there are certain points that are worth re-iterating.

In particular, the Commission noted that in the case of airlines, an increase in prices charged by Airservices presents them with options ranging between:

1. absorbing the increase, affecting airline profitability; or
2. passing the increase on to consumers, affecting the price of the airfare.

In practice, some combination of the two is likely.

14.3.1 Impact on airlines

An airline's ability to absorb cost increases depends on the environment in which it is operating. Airlines are more likely to absorb cost increases if they are faced with competitive pressure. As with last year, a number of comments have been received on this issue.

⁶⁶ HeliAust submission, 30 April 2003.

For example, in its submission, GCAL refers to the importance airline users place on differentials between major capital city airports and the larger regional airports when looking at new route development initiatives. The Queensland government has also expressed concern about the impact of the proposed prices on regional destinations and HeliAust's submission suggests that, given the short length of many of its flights, any increase in the prices charged by Airservices may result in a number of its services becoming loss making.

Other submissions received have been strongly opposed to any increases in prices charged by Airservices, pointing to a current industry downturn. Elsewhere in this Preliminary View document, the Commission has recognised that the aviation market is indeed currently experiencing marked instability. As such, the Commission has noted submissions from IATA, Qantas and Mackay Airport which question airlines' ability to absorb any further price increases.

As noted by Virgin Blue, international airlines and routes are more likely to be suffering from the effects of SARS, war in Iraq, as well as the continued threat of terrorism. In this respect, IATA's comments regarding the extent of the losses expected to be incurred by international airlines are unsurprising. The effects of such losses on the level of competition between international carriers – and thus the extent to which cost increases can be absorbed – are, however, less clear-cut.

While domestic airlines have to date been less affected by current international events, the Commission notes that unlike last year's notification (which proposed price increases to en-route, ARFF and TN prices), the current notification does not propose any changes to enroute charges. Increases are only proposed for ARFF and TN prices. Since international airlines are only likely to fly into a small number of those airports affected by the proposed changes, the proposed charges are likely to have a more significant impact on the domestic market and domestic airlines.

The Commission has undertaken some analysis of the effect a price increase might have on both domestic and international users. Using passenger volume⁶⁷ figures provided by airports for the Commission's 2001/02 Phase I and II Regulatory Reports, as well as confidential volume information supplied by Airservices, the Commission has estimated the dollar impact of the proposed price increases at each of the airports where Airservices proposes to increase ARFF and TN charges.⁶⁸

The analysis suggests that the impact of the proposed price increases would be noticeably more significant for domestic users than for international users. Specifically, the Commission's analysis indicates that, over and above the current prices, the proposed price increases will result in Airservices earning approximately \$3.8 million additional revenue from international users and \$12.3 million additional revenue from domestic users in 2003/04.

⁶⁷ Domestic and international tonnage volumes at each airport are not available, so passenger volumes were used as a proxy.

⁶⁸ It should be noted that for smaller airports not subject to the Commission's regulatory reporting (Hamilton Island, Mackay and Rockhampton airports), 100% of traffic was allocated as domestic. For Cairns Airport, which does have some international services, a conservative assumption that 50% of traffic is international was used.

Nonetheless, for the reasons set out in section 14, the Commission is of the view that Airservices' proposed approach to increasing its revenues would not be unreasonable, given that many of these services appear to be currently provided at a loss. Furthermore, it may be the case that these increases are passed onto passengers through higher ticket prices.

14.3.2 Impact on travellers

Some submissions have highlighted the impact these proposed price changes would have on travellers using regional and rural airports, where few, if any large domestic or international flights may land. Using itself as an example, Mackay Airport concludes that while Airservices has estimated the lowest increase on major domestic routes to be \$0.43 per return trip for Sydney/Melbourne flights, the increase for a Brisbane/Mackay flight (which the Airport states is a similar distance) will be \$4.02.

Submissions received from Qantas and Virgin also suggest that given the current climate, airlines can only absorb *some* of the cost increases, and that ultimately they will be passed onto consumers.

Airservices' position is that it expects the proposal to only result in small percentage increases to the prices paid by airlines and passengers, and that it does not believe this will result in a fall in demand. This analysis assumes that airlines fully pass on all cost increases to passengers. The percentage increases estimated by Airservices range between 0 to 0.4% per passenger.

The question as to whether Airservices' proposal will have an effect on the demand for services by either direct or end users is an important consideration. If an increase in prices leads to reduced activity and therefore revenue for Airservices, then the proposed new prices may in fact be counter productive and lead to a further contraction in demand.

The affect on demand would differ across different locations, which reflects different demand elasticities for the services. For example, demand at locations where passenger traffic contains a higher proportion of tourists is likely to be more sensitive to price changes than at those locations where there is more business-related travel. Demand elasticities will also vary with the level of airfares – in general, the lower the fare the greater the sensitivity to prices. On the basis of the latter point, it is likely that increases would have a greater impact on regional, rather than international, travellers.

While the Commission notes the concerns of interested parties over the possible effects of the proposed increases on demand, it appears that any consequential increases to airfares would be relatively small. In this respect, it appears unlikely that consumers' travel decisions would be greatly affected.

14.4 Conclusion

The Commission acknowledges concerns that any further increase in prices charged by Airservices Australia could result in a contraction of demand for some services, and also create a risk that certain routes become less viable. However, it does not

appear that the increases in airfares that might result from the proposed pricing would materially affect consumer demand. The Commission is therefore more concerned in the current case to be satisfied that Airservices' overall level of pricing reflects the cost of providing services over the medium-term.

Part C: Conclusion

15 Preliminary View

15.1 The Commission's options

In responding to Airservices' notification, there are several options open to the Commission. These include:

1. Not objecting to the proposed price increases;
2. Objecting to the proposed increases and requiring prices to revert to the levels prevailing in June 2002 (which are lower than current prices); or
3. Objecting to the proposed increases but not objecting to a continuation of current prices for a further twelve months.

15.2 Summary

Airservices is proposing price increases based essentially upon increased costs and weaker than previously expected traffic volumes for the 2003/04 financial year.

The building block analysis provided by Airservices in its response to the Commissions Preliminary View is set out in table 15.1 below. By way of comparison, an analysis setting out the values that would prevail in the event that the 10% mark-up on asset values was removed, and the asset beta adjusted downwards, as discussed in sections 9 and 10, is also provided.

Table 15.1 : Building Block Calculations 2003/04

BUILDING BLOCK CALCULATION 2003/04 (DUAL TILL)		
	Airservices	ACCC
Indicative Revenue Estimation		
Return on Capital for Regulated Assets	\$33.9m	\$28.3m
Return of Capital for Regulated Assets	\$58.9m	\$53.6m
O&M Regulated	\$444.2m	\$444.2m
+ Net taxation payable	\$9.2m	\$7.4m
- Dividend Imputation Benefit	(\$4.6m)	(\$3.7m)
= Net Indicative Revenue	\$541.6m	\$529.8m
Total Airways Revenue at proposed prices⁶⁹	\$518.3m	\$518.3m
Over / (Under) Indicative Revenue	(\$23.3m)	(\$11.5m)
Less net CSOs (Subsidy less Costs)	\$11.1m	\$11.1m
Net Over / (Under) Recovery	(\$12.3m)	(\$0.4m)

⁶⁹ Includes subsidy.

On the basis of Airservices' modelling presented above, it would earn \$12.3m less than its 'indicative' revenue in 2003/04 at its proposed prices. On the alternative modelling approach, it would earn approximately the indicative amount.

Submissions to the Commission have generally opposed any price increases, noting the difficulties currently facing the aviation industry, and that Airservices' approach to pricing exacerbates such difficulties by seeking to increase charges in times when demand is weakest. Furthermore, a number of submissions point to the issues identified by the Commission in its previous decision on Airservices' pricing in July 2002, arguing that Airservices has failed to address these in its current proposal.

While on the basis of the financial modelling provided by Airservices, the proposed price increases should allow it to earn a return in 2003/04 close to its weighted average cost of capital, it is not clear that this is an outcome that should be expected, given the current difficulties facing the aviation industry. Rather, a forward-looking, longer-term perspective on pricing and returns might suggest that a low return in one period is compensated through higher returns in others. Over time, a reasonable average return can therefore be generated.

In this respect, a significant issue that Airservices has not addressed in its submission is the short-term nature of its pricing approach and the impact this has on its users. The Commission has significant concerns about the negative effects of pricing that runs counter-cyclical to demand; for example, greater uncertainty over airlines' costs could increase the variability of cash flows and thus the risks associated with investment in that industry.

In reaching its preliminary view, therefore, the Commission's strong preference for a longer-term pricing model must be weighed against the short-term financial considerations outlined above.

Indicative modelling undertaken by the Commission suggests that at current prices, and assuming activity growth averages around 2% per annum, Airservices would earn returns close to its proposed weighted average cost of capital over a five year period if it could generate real cost savings of around 4% per annum.⁷⁰

As however, Airservices' activity growth over the past seven years averages around 1.5% and includes the results from 2001/02 (-9%) and 2002/03 (-0.1%) which are amongst the worst performing years for the aviation industry this also suggests that a longer term growth rate of 2% is likely to be conservative.

The Commission would therefore expect that a proposal to increase prices over the longer-term would, at a minimum, need to make a case as to why these parameters are not achievable.

15.3 Conclusions

⁷⁰ [This analysis uses current costs as a starting point. Capital costs are based on the book value of assets.](#)

The Commission's discretion under the PS Act is essentially limited to objecting or not objecting to price notifications put before it.

The pricing proposal put forward by Airservices fails to address issues previously identified by the Commission, such as operating efficiency incentives and asset valuation. In this respect, Airservices has not made a strong case for price increases, particularly at a time in which the aviation industry as a whole is under significant duress.

In particular, Airservices has failed to address the Commission's preference for a longer-term approach to pricing, instead seeking temporary price increases on the basis of short-term cost and activity forecasts.

In such circumstances, the Commission considers it is obliged to object to Airservices' proposal as it currently stands. Were it to act otherwise, there would be little incentive for Airservices to resolve the issues identified. Most particularly, there would be little incentive for Airservices to work with its customers towards agreeing upon a longer-term pricing model, with the attendant advantages identified in this decision.

The Commission acknowledges, however, that Airservices has taken steps to address issues previously identified in relation to CSOs and dual till. Furthermore, the Commission notes that there may currently be some cross-subsidisation of the costs of terminal navigation and ARFF services by charges for en-route services.

On balance, though, the Commission's final decision is to object to the current price notification. While Airservices' proposal may be acceptable in a structural sense, such issues can and should be accommodated within a longer-term pricing model.

In reaching this final decision, the Commission reiterates its preference for Airservices to adopt a longer-term pricing model. This could range over a period of 3-5 years. While recognising that such a change cannot necessarily be effected immediately, the Commission encourages Airservices to negotiate with users to develop a pricing approach which facilitates sharing of volume risk, allows a greater degree of certainty and mitigates the current counter-cyclical nature of charges for its services.

Commission Decision

The Commission's decision is to object to Airservices' proposal to temporarily increase charges for terminal navigation and aviation fire-fighting and rescue services for 2003/04.

The Commission's decision is to not object to prices for these services remaining at current levels (as set out in table 15.2) for a further twelve months; ie until 30 June 2004.

Table 15.2: Airservices' pricing 2003/04

	Airservices Proposed Prices	ACCC Endorsed Prices
Terminal Navigation (TN)		
Adelaide	\$10.42	\$9.74
Brisbane	\$5.30	\$4.96
Cairns ⁷¹	\$9.36	\$8.75
Canberra ⁷²	\$10.16	\$9.50
Coolangatta ⁷³	\$10.68	\$9.99
Melbourne	\$3.69	\$3.45
Perth	\$8.01	\$7.49
Sydney	\$5.15	\$4.82
Aviation Rescue and Firefighting (ARFF)		
Brisbane	\$1.56	\$1.46
Melbourne	\$1.17	\$1.09
Perth	\$2.57	\$2.40
Sydney	\$0.74	\$0.69
Adelaide	\$2.88	\$2.69
Cairns	\$4.10	\$3.83
Coolangatta	\$4.53	\$4.24
Darwin	\$7.73	\$7.23
Alice Springs	\$7.28	\$6.81
Canberra	\$3.83	\$3.58
Hobart	\$9.05	\$8.46
Launceston	\$9.95	\$9.30
Mackay	\$15.86	\$9.98
Rockhampton	\$14.02	\$9.59

⁷¹ TN prices at Canberra, Coolangatta and Cairns for aircraft weighing less than 5.7 tonnes remain capped at \$7.42.

⁷² TN prices at Canberra, Coolangatta and Cairns for aircraft weighing less than 5.7 tonnes remain capped at \$7.42.

⁷³ TN prices at Canberra, Coolangatta and Cairns for aircraft weighing less than 5.7 tonnes remain capped at \$7.42.

Appendix A: List of submissions

The Commission received submissions from the following parties regarding Airservices' draft price notification:

- Board of Airline Representatives Australia (BARA)
- International Air Transport Association (IATA)
- Qantas
- Gold Coast Airport
- Mackay Airport
- Virgin Blue
- Regional Airlines Association of Australia (RAAA)
- Queensland Government
- HeliAust Pty Ltd

The Commission also received submissions from the following parties in response to its Preliminary View:

- Airservices
- BARA
- IATA
- Qantas
- Gold Coast Airport
- Virgin Blue
- Mackay Airport

The submissions are available on the Commission's website at <http://www.accc.gov.au/airport/airserv.html>.

Appendix B: International experience

Given Airservices' comments regarding the impracticality of long-term pricing, the Commission has examined the recent experiences of overseas air navigation providers and regulators. The Commission acknowledges that care needs to be taken when comparing Airservices with overseas operators as there may be variations between the operating environments. Nonetheless, it is worth noting the responses of other service providers to the current weakness in demand.

In Canada, for example, the provider of civil air navigation services, NAV CANADA, has recently released its financial results for the three and sixth month periods ended February 28, 2003. NAV CANADA is mandated to collect revenues that meet the costs of providing air navigation services. NAV CANADA plans its operations in response to an annual breakeven position after expenses have been met through customer service charges and other revenue sources, and after adjustments have been made to its rate stabilisation account.

As with Airservices, NAV CANADA is currently experiencing a downturn in activity. However, in addition to the ramifications of September 11, 2001, the slowdown of the global economy, the war in Iraq, and SARS on traffic volumes, NAV CANADA also faces uncertainty as to debts owing by Air Canada and its affiliates. NAV CANADA's largest customer, Air Canada recently obtained an order providing protection from its creditors.

In view of these developments, NAV CANADA has announced that it will increase its customer service charges effective August 1, 2003. The Commission notes that the amount of the increase is intended to achieve breakeven results in the 2004 financial year, as well as recover the estimated revenue shortfall as of August 2003 **within five years**.

Similarly, in the UK, the Civil Aviation Authority (CAA) has recently announced its decision to allow the application by National Air Traffic Services' (NATS) to amend the cap on charges to airlines for en route charges. After being separated from the Civil Aviation Authority, NATS' UK en route and North Atlantic traffic charges have been subject to economic regulation since 1 April 2001, when a 5 year price path was adopted.⁷⁴ Applying an RPI-X price cap, the CAA initially announced an X of 3% for 2002, 4% for 2003 and 5% for each of 2004 and 2005.⁷⁵

In response to financial difficulties faced by NATS, however, the CAA released a decision in March 2003 allowing a number of changes to the price controls. These included changes to the price cap, which from 2003-05 has been adjusted to RPI – 2 percent per annum, replacing the original cap. Furthermore, between 2003 and 2005, NATS will face no more than 50 per cent of volume risk (compared with 100% previously). This implies that, above a floor, if chargeable units rise or fall by a certain amount compared to a benchmark level, prices will fall or rise so that NATS

⁷⁴ Information obtained from www.nats.co.uk. The Commission acknowledges that NATS accepts no responsibility for the information included in this report.

⁷⁵ NATS, *Application to Reopen the Eurocontrol Charge Control*, February 2002, p1.

En Route Ltd (NERL) loses or gains only 50% of the revenue compared with a situation without volume sharing.⁷⁶

As already stated, the Commission is aware of the difficulties posed by international comparisons. However, it does note that, faced with similar conditions to Airservices, NAV CANADA has sought to achieve break-even results for the 2004 fiscal year. In contrast, Airservices' notification proposes a reduction in its rate of return.

Furthermore, both NAV CANADA and NATS have been able to determine 3-5 year forward looking plans. The Commission, in its decision to not object to Airservices' 2002/03 price notification, recommended that Airservices adopt longer-term price paths for future notifications.

Notwithstanding Airservices' present comments to the contrary, the experience of air navigation providers in the UK and Canada suggest that, despite the currently volatile aviation market conditions, the adoption of a long-term price path by Airservices should still be possible.

⁷⁶ Civil Aviation Authority, *NATS' Application to Reopen the Eurocontrol Charge Control – CAA Decision*, March 2003.