

17th January 2011

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Long Term Pricing Agreement Review
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Dear Andrew

REF: LONG TERM PRICING AGREEMENT REVIEW

As a little background, and as your consultation document rightly indicates, you are well aware that although our industry is starting to recover from years of economic and other external shocks, which has left the industry financially scarred from several loss-making years, the recovery is not assured. Other continuing adverse effects, including United Kingdom ("UK") Air Passenger Duty (and the increasing tax burden on aviation generally), new generation aircraft delivery delays, rising fuel prices and repeated weather-related operational traumas, continue to exert significant negative financial impacts on our industry. We therefore reiterate our appreciation for the actions that Airservices Australia has taken over recent years that, to some degree, has mitigated the negative impacts on our industry, including the price path since the significant shock in 2001 that consistently tracks below Australia's inflation rate.

However, we are now looking forward for the next five-year period and the creation of a successor to the existing Long Term Pricing Agreement ("LTPA"). British Airways ("BA") welcomes the opportunity to contribute its input to this process and we encourage Airservices Australia to use this opportunity to effect change, as detailed in this letter.

In summary, Airservices Australia's proposal, on an average weighted basis, is forecast to deliver year-on-year reductions in real terms, which is welcome. However, Airservices Australia, in nominal terms, is still asking airlines to pay more during each year of the five-year agreement.

Before providing specific feedback on Airservices Australia's proposal, I'd like to start by providing you with feedback on some broad issues:

Aircraft Weight in Charging

As has been widely accepted by Air Navigation Service Providers ("ANSPs") around the world, aircraft size has minimal, if any, impact on the cost of providing Air Traffic Control ("ATC") services. Therefore, given the ICAO principles of cost-relatedness and equity, charging related to weight must be fundamentally flawed. On this basis BA does not accept the argument of pricing based on the 'ability to pay', as this is itself flawed, as this would assume that Airservices Australia has the ability to differentiate the economic value being generated by different aircraft types, or indeed questions how Airservices Australia can ascribe the same economic value to the same aircraft type being operated by different carriers. Clearly this is not a logical or appropriate way to calculate ATC charges.

BA, therefore, requests that Airservices Australia gives due consideration to migrating to ATC charges that are based on aircraft movements rather than aircraft weight.

I will make some further specific comments on the way that Airservices Australia is proposing to structure its charges in relation to weight later in this response.

Cross-Subsidies

Cross-subsidies, by their very nature, mean that one or more airlines are carrying costs through Airservices Australia's charges, which reduce the cost burden of another airline or airlines. This distorts competition, is against best business practise and is in breach of ICAO policies.

We therefore request that Airservices Australia makes further progress in removing the cross-subsidies, e.g. between different aircraft types, between international and regional/General Aviation ("GA") airports, or between en route and terminal navigation services. It is of particular concern that all of the above examples of cross-subsidisation disadvantage international airlines, which by the nature of our businesses facilitate international trade and hence generate greater economic wealth for Australia than regional/domestic operations.

The continued use by Airservices Australia of price capping on the basis of city basins and regions, is another way that charges are allowed to be unrelated to costs, and hence another way in which cross-subsidies are created.

BA therefore reiterates our objection to cross-subsidisation and requests that Airservices Australia commences a process, to be completed during the term of the next LTPA, of removing all cross-subsidies, which should create the appropriate economic framework and stimuli to achieve sustainable models for airlines, airports and indeed Airservices Australia itself.

Cost Transparency

Linked in some ways to the issue of cross-subsidy is cost transparency, as with greater cost transparency comes the ability to gain comfort that Airservices Australia is allocating its costs appropriately in relation to the services that it provides.

Greater cost transparency will also allow your airline customers to gain a greater insight into the operating and capital expenditure performance of Airservices Australia.

Therefore BA requests that Airservices Australia provides its customers with greater granularity of its operating and capital costs, including both direct and allocated costs, broken down by location and/or service. We would also request that Airservices Australia provides a breakdown of its employee numbers, split by Air Traffic Control Officers ("ATCOs"), support staff and administration staff, again split by location and/or service.

I would now like to focus on a number of specific issues that have been identified as concerns in your consultation paper:

Weighted Average Cost of Capital

You will be aware that due to the marginal nature of the airline industry, our cost of equity will be far lower than that of Airservices Australia, even during the increasingly rare positive periods. In fact, due to the various external shocks to our industry, BA has only been able to pay one interim dividend to our shareholders since 2001.

Following the recent regulatory reviews of Heathrow Airport Ltd, Gatwick Airport Ltd and NATS (En Route) plc, we have a sense of where a key economic regulator, being the UK's Civil Aviation Authority, believes that a regulated monopoly's Weighted Average Cost of Capital ("WACC") should be set. It should be said, however, that BA's independent economic advisors (Cambridge Economic Policy Associates) believe that the WACCs set for these regulated monopolies (which range from 6-7%) are still higher than are required to provide these companies with an appropriate level of return, certainly when considering the relative risk positions of airports and ANSPs versus airlines and other companies operating in competitive industries.

We therefore cannot accept the build-up to the proposed WACC of 9.42%, which is overly generous, even to a business operating in a competitive environment, which is exposed to real commercial risk. By including risk-sharing mechanisms within the LTPA, Airservices Australia is already seeking to mitigate an already low commercial risk, and hence BA stresses that a WACC in the range of 6.5 – 7.5% is far more reflective of the nature of an ANSP's risk profile, rather than an excessively generous 9.42%. Adopting a WACC of, say, 7%, would allow Airservices Australia to deliver decreasing pricing in nominal terms throughout the LTPA period.

General Aviation

I will not re-run in detail the well-worn, but still very relevant, arguments regarding why the commercial aviation sector believes that the continuing cross-subsidisation between commercial aviation and GA should be addressed, and urgently, not only in Australia, but worldwide.

In simple terms, and to reiterate my earlier general point, cross-subsidisation is wrong and can drive perverse behaviours. GA must be required to pay their way by covering the fully allocated costs associated with provision of ATC services by Airservices Australia. If Airservices Australia believes that GA isn't able to cover its full costs, it is still not appropriate that commercial aviation subsidises GA. However, if the Australian government believes that there is an economic or social case to enable GA to continue operating at the current subsidised level of charges, it should consider providing a contribution from general taxation to ensure that the cross-subsidy ends.

On a specific point, Airservices Australia proposes (for the sake of reducing its administration costs) to only apply charges for GA above \$500. BA would appreciate Airservices Australia providing clarity as to how this would work in practice, as it appears that this raises a risk of even greater cross-subsidisation. In practice should a GA operator undertake three air traffic movements, each incurring ATC costs of AUD200, does Airservices Australia's proposal mean that the actual charge to that operator would be (i) AUD0, as each sector was below AUD200, (ii) AUD600, as the total breaches the AUD500 threshold, or (iii) the marginal AUD100, being the value above the threshold of AUD500?

Aircraft Weight in Charging – Specific Points

Weight Capping

Airservices Australia is proposing applying a weight cap at 500 tonnes, which clearly only benefits A380 operators, which, by default, causes a level of cross-subsidisation from all other carriers. While BA believes that the appropriate policy in charging for ATC services is that there should not be a weight element, BA equally rejects unfair or inequitable treatment that specifically benefits or disbenefits a small sector of Airservices Australia's customer base.

The effect of Airservices Australia's above proposal in relation to charges in 2012 for the SIN-SYD sector is a reduction in ATC charges of 7% for A380 but an increase of 2.53% for 747. This amounts to discriminatory pricing, which is unacceptable unless it is clearly the first part of a path to a single unit rate irrespective of aircraft weight.

Aircraft Categories

Airservices Australia utilises aircraft categories, up to category 10, but it is not totally clear which aircraft types fall into each category, therefore BA request confirmation from Airservices Australia on this point.

Airservices Australia's consultation paper states that Perth Airport required capital investment to upgrade it (from an Aviation Rescue & Fire Fighting perspective) to accommodate category 10 aircraft, however even the largest current aircraft appear to fit within the definition of category 9. Please can Airservices Australia explain this apparent anomaly.

Average Maximum Take-Off Weights ("MTOW")

Airservices Australia has not made clear what the administrative cost saving is that it achieves by using average MTOWs, so can Airservices Australia please provide this. However, in principle, BA doesn't agree with this practice unless, again, it is a step on the road to removing weight from the charging formulae.

BA is happy to provide Airservices Australia with our annual fleet lists on request, which allows for fairer charging, albeit within a structure that is itself unfair and inappropriate.

Aviation Rescue & Fire Fighting ("ARFF")

Can Airservices Australia please explain the rationale, and provide the cost transparency, that justifies why it uses different unit rates for different aircraft categories for ARFF services?

Further, can Airservices Australia please explain, again providing cost transparency, which justifies higher percentage increases for heavier aircraft. For example, at Sydney Airport, Airservices Australia is proposing a 46% increase during the new LTPA for category 9 & 10 aircraft, versus a 23% increase for category 6 aircraft.

We look forward to receiving your response to this letter in due course.

Yours sincerely



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PROCUREMENT MANAGER
AIRPORTS & ATC

cc Dave Wood
Rajiv Anand

