



**IATA Submission in response to Airservices Australia
Draft Price Proposals for the LTPA 2011-16**

11 Feb 2011

Summary

This submission presents the response of the International Air Transport Association (IATA). IATA's mission is to represent, lead and serve the airline industry and brings together 230 member airlines whose flights account for 93% of all international scheduled air traffic.

IATA welcomes this opportunity to submit its comments to Airservices Australia (AsA) regarding its Draft Pricing proposal for 2011-2016 discussion paper. IATA's comments are from an international perspective and are based on the requirements of, and practices in, international civil aviation.

Overall, IATA considers that AsA should review its proposals and incorporate the recommendations provided in the present document in order to ensure user's agreement to a long term pricing contract.

IATA's positions in the present document have been structured along 3 parts: tariff structure, level of charges and other proposals. The main messages are highlighted below:

Part 1: Tariff structure proposals:

- The tariff structure includes a number of cross subsidies among different users; many of which worsen over the 2011-16 period. Cross subsidies should be eliminated.
- AsA should implement separate charges for en route oceanic services. Such pricing would reflect the costs differential for providing these services. Such practice could also be extended within the continent in order to reflect the higher costs of providing the services at more complex areas.
- The proposed weight cap is too high and therefore does little to minimize the effect of weight on charges. In the present document IATA provides two alternatives on how to deal with this.
- AsA needs to present a business case (i.e. cost-benefit analysis) for proposing the AUD 500 threshold on General Aviation.
- Average MTOWs can be applied, unless an airline provides information that would merit a change in the weight figure on its own.
- Rebates generated by revenue from non-airside callouts are welcome. These should be given to users from overcharged locations that cross subsidize loss making ones

Part 2: Level of charges proposals

- Historic regulatory accounts need to be provided. These would allow users to analyze AsA's historic performance as well as establish a historic "base" year on which forecast costs could be compared.
- AsA has not provided adequate benchmarking information that could show how close the ANSP is in relation to efficiency frontier. Such action ignores the ACCC recommendation back in 2005, and makes difficult to formulate an adequate assessment of AsA's operating costs. Operating cost increases cannot be justified without such benchmarking tool.
- It appears that AsA overcharged users in the 2005-09 by forecasting a higher level of depreciation than the one actually incurred. This needs to be corrected through an adjustment to the opening asset base for 2011-12.
- The 2011-16 capital expenditure program is unusually big compared to AsA's historic level of investment. Moreover, the rate of "renewals" suggests that the life of the entire asset base is 10 years. This is unacceptably low.
- In addition, the rate of increase in the depreciation is significantly higher than the rate of increase in the asset base. This could be a consequence of an unjustified low life assumed for the new assets. AsA should clarify this.

- AsA has budgeted AUD 191 million of capex for the “ATM future systems” project without providing much detail. Such project should be removed from the program until better information is available. IATA suggests two alternatives on how to deal with this.
- AsA should amend its WACC assumptions on risk free rate, debt margin and gearing. It is of particular concern that AsA is not using its current credit rating (AAA) as the basis for setting the debt margin.
- AsA has included in the building blocks what could be considered “contingency” costs for potential new service locations. These need to be eliminated. If services for new locations are needed and confirmed, then charges should be consulted and revised to reflect the impact of this particular issue on the level of charges (without the need to review costs for other services in order to preserve the appropriate incentive mechanisms).

Part 3: Other Proposals

- The current revenue sharing the most adequate given the current stakeholder positions.
- The Capital expenditure sharing arrangement is acceptable as long as users are allowed to claim adjustments at the end of the period, even in the event were the undelivered capex is below the 25% threshold. In addition, there is a need to implement the cumulative threshold of 25% to the first year of the period (and not only starting from year 2).
- There is no demonstrated link between the capital expenditure program and the targets included in the Service charter
- The Service charter does not include financial penalties should the targets are not met.

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Part I: Tariff Structure proposals

1) Cross subsidies

IATA does not support any type of cross-subsidies. Cross subsidies impose an unjustified cost burden to a particular segment of users; they distort competition as well as violate ICAO policies.

Unfortunately, AsA's proposed charges structure allows for large cross subsidies among different users within a service as well as cross subsidies among different services. These are explained below:

a) Subsidies from En route activities to Terminal and ARFF activities

AsA is quite clear in explaining that en route users subsidize Terminal and ARFF service. This has been happening for quite a long time and expected to continue (though decreasing) in the medium term.

For instance, AsA forecasts that the level of en route subsidy to the remaining service areas in 2011-12 will be AUD 34.8 million. Although AsA forecast that such level "shrinks" to AUD 11.6 million by 2015-16¹, en route users would be paying more than AUD 100 million over the 2011-16 period in subsidies.

Such practice is not acceptable. En route users should not be subsidizing other service categories. This distortion should be eliminated as soon as possible.

b) Cross subsidies among Terminal locations

AsA provides a large explanation on how it has allocated costs among each Terminal location. It also emphasizes that the result of this exercise forms the basis for setting charges. However, such approach turns meaningless once AsA implements regional and city basin caps.

IATA has a number of concerns in relation to the location specific information provided by AsA (building block costs, asset base, EBIT). These are explained below:

- Most of the terminal areas do not generate enough revenue to even cover their operating costs. As such, they are being subsidized either by revenue from other (larger) Terminal areas or by en route revenue.

More worryingly, the situation does not improve over time, as 12 out of the 13 loss-making (EBIT < 0) terminal locations in 2011-12 are forecast to generate even greater losses by 2015-16. It is clear that limiting price increases by the level of inflation is not enough to demonstrate that AsA is taking a path for eliminating cross subsidies among locations.

- The terminal areas that provide the highest level of cross subsidies (in value) are Sydney, Melbourne, Brisbane, Perth and Adelaide. In most cases, this return is more than double the WACC requested for AsA as a whole. This is reflected in Table 1. Such practice is unfair towards the users paying charges in these locations.

¹ Last slide of the PCC meeting presentation (December 2010)

Table 1: AsA Draft Price proposal: Overall WACC vs. forecast return on capital for major locations (2015-16)

Major terminal location	Requested AsA overall WACC – Price Proposal	Forecast return on assets 2015-16
Adelaide	9.42% + tax	27.3%
Melbourne		26.7%
Perth		21.8%
Brisbane		19.8%
Sydney		19.6%

Source: AsA

- The most subsidized terminal zones are those classified as part of Capital City basins. If charges at these highly subsidized terminal areas were increased to at least to cover their operating costs (not even to cover their cost of capital), charges at capital cities (Sydney, Melbourne, Brisbane, Perth and Adelaide) could be some AUD 27 million lower per year.
- Although AsA claims in its price proposal that capital cities only subsidize terminal areas within their city basin, this does not hold true when numbers are analyzed. For instance, Table 2 shows the total (i.e. combined) return on assets from all locations per city basin for 2015-16. In all cases, the return on assets is much higher than the claimed WACC of 9.42%. This implies that the excess return is being used to subsidize other service areas.

Table 2: Return on assets of the Capital basin areas (2015-16):

City basin area	Combined average asset value	Combined EBIT	Return on Assets*
Sydney + Bankstown + Camdem	AUD 103.3 m	AUD 15.5 m	12.6%
Brisbane + Archerfield	AUD 58.5 m	AUD 8.3 m	12.7%
Melbourne + Essendon + Moorabin	AUD 69.1 m	AUD 10.2 m	13.2%
Adelaide + Parafield	AUD 32.5 m	AUD 3.7 m	10.7%
Perth + Jandakot	AUD 49.1 m	AUD 6.8 m	11.4%

* Reference WACC (as per AsA): 9.42% + tax

Source: AsA

Based on the above, IATA does not consider that the following AsA statement is correct:

“Taking into account service costs and flight activity volumes the proposed prices for each location have been established to transition along a path from the current price to a price in 2015/16 that reflects the total allocated cost of the service over time”

IATA urges AsA to reconsider the current Terminal charging structure in order to eliminate all of the current distortions.

c) Subsidies among different ARFF service locations

The decision to apply network pricing for category 6 aircraft has generated a significant level of cross subsidy from large to smaller regional location.

From the location specific information provided by AsA, it can be seen that Sydney’s ARFF is at the top of the list with the highest expected return on capital with a massive 146% in 2011-12 (increasing to 210% by 2015-16). This is by far in excess of the requested 9.42%. Moreover, it can also be how the profits generated by the top 5 locations subsidize the remaining 18 locations. This is shown in Table 3.

Table 3: Return on capital at the 5 biggest contributors versus the rest of ARFF locations – 2015-16

ARFF Locations	Combined average asset value	Combined EBIT	Return on Assets*
Sydney, Melbourne, Brisbane, Perth and Adelaide	AUD 63.4 m	AUD 70.7 m	111.5%
The rest (16 existing + 2 new locations)	AUD 131.2 m	AUD -53.2 m	-40.6%
Total (21 existing + 2 new locations)	AUD 194.6 m	AUD 17.4 m	9.0%

* Reference WACC (as per AsA): 9.42% + tax

Source: AsA

As with terminal charges, the level of cross subsidy from larger to smaller locations worsens over the period. For instance, while the EBIT generated by the top five locations increases in AUD 35 million (from AUD 35.7m to AUD 70.7m) between 2011-12 and 2015-16, the accumulated EBIT of the remaining locations decreases in AUD 6.4 million (from AUD -46.8m to AUD -53.2m) over the same period.

To make matters worse, AsA still forecasts additional cross subsidies of en route services in order to reach the overall AsA's proposed WACC.

In conclusion, it cannot be accepted that only a handful of ARFFs finance all the remaining service locations. AsA should remove the distortion created by the network pricing for category 6 services as soon as possible.

d) Cross subsidy among en route users

This issue is being dealt in Part I Section 3. It relates to the distortions generated from the usage of a weight factor as part of the en route charging formula.

2) Oceanic Pricing, Continental pricing

Due to the extensive geographic scope of en route services provided by AsA, there potentially exist differences in the level and cost of en route services provided to different users based on their location – continental or oceanic. Furthermore, for continental services, there is marked difference in complexity between the East Coast and other parts of Australia. A thorough analysis is required of the cost base (infrastructure, manpower, overheads) for en route services for each of these user groups. Unit rates can then be developed based on respective traffic levels. In summary, IATA urges AsA to restructure en route service charges to better reflect the differences in service costs for different en route service users. This effort should be taken at the earliest given opportunity and the outcome incorporated into the pricing model for 2011-2016.

3) En route: Weight Cap

IATA has stated on repeated occasions that weight is not the appropriate driver for setting Air Navigation Costs.

Weight has little influence on ATC services and is more likely to constitute an “ability to pay” measure². Weight charging formulas are a perverse incentive to increase the number of smaller planes, which in turn causes the ATC provider to incur in higher costs to increase its capacity (funded, again, by users with heavier aircraft).

² In other words, this practice constitutes an additional cross-subsidy at AsA.

For instance, during 2010 there were 10 types of aircraft flying between Sydney and Melbourne. Despite the fact all aircraft are sharing the same distance, same city pair and same passenger types, the smaller aircraft would pay 60% less than the heavier one. Such pricing formula cannot be economically efficient. This is shown in Table 4.

Table 4: Weight factor applied for aircraft flying from MEL to SYD in 2010.

A/C type	Body	Number of flights in 2010	A/C MTOW	Weight Factor for en route charges*	charge index A330-200 = 100
A330-200	Wide	1,554	230.4	15.2	100
A330-300	Wide	322	229.5	15.1	100
B767-300	Wide	12,539	171.5	13.1	86
A321	Narrow	280	91.9	9.6	63
B737-800	Narrow	5,616	77.8	8.8	58
A320	Narrow	7,804	74.8	8.6	57
B737-400	Narrow	2,583	67.3	8.2	54
B737-700	Narrow	17,205	66.9	8.2	54
E-190	Narrow	402	51.8	7.2	47
E-170	Narrow	667	37.2	6.1	40

* Weight factor: SQRT (MTOW)
Source: Traffic: IATA SRS Analyser, Weight: AsA published average MTOW per A/C

IATA's position is that ATC en route charges should be solely based on distance (and ultimately, on time). As such, there should be a complete separation of weight in the structure of charges.

In order to partly recognize such concerns, AsA is currently proposing the introduction of a weight cap. However, the proposed threshold (500tn) is meaningless, as only one aircraft type will surpass such weight level. Moreover, such move could even be considered as anticompetitive.

Although IATA's position is to eliminate weight entirely from en route charges, and in order to bring the discussions forward, IATA proposes the following two interim alternatives to be applied in the en route formula for the present Long term agreement:

Alternative 1: Introduce a cap for aircraft with weight above 136 tones (these are the so-called "heavy" aircraft as defined by ICAO).

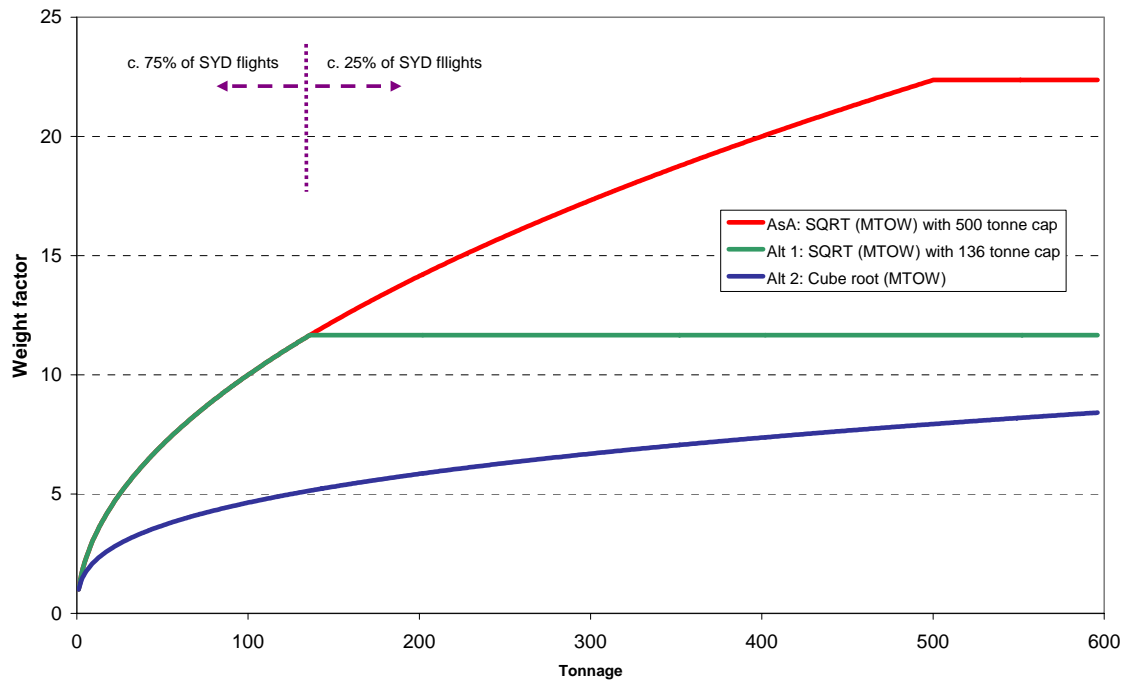
As a reference, around 25% of Sydney's flights are from aircraft with MTOW above 136 tones. Also, this weight is in the range of transition between narrow and wide body aircraft. As more aircraft will pass the proposed threshold.

As more aircraft would qualify, it is believed that the proposed threshold would reduce any risks of generating competition issues.

Alternative 2: Change the formula from "square root of MTOW" to "cube root of MTOW". The curve generated by utilizing a cube root is much flatter and reduced the impact of weight on charges.

Both alternatives (compared to the current status) aim to better recognize the greater productivity and efficiency brought by heavier aircraft operators.

Figure 1: Effect of different charging formulas on the en route weight factor (AsA and IATA proposals)



In future Long term arrangements, weight should then be eliminated in its entirety.

4) General Aviation Threshold

Users need to pay their fair share of costs. AsA's proposals imply an additional cross subsidy to an already cross-subsidized charge. Unless AsA can provide an appropriate business case (i.e. a cost-benefit analysis) supporting this proposal, IATA will not support such move.

5) Average MTOW

AsA should specify how much is being saved by such initiative. As an alternative measure, AsA could initially apply an average MTOW to an aircraft, and only apply specific MTOWs should an airline provided the appropriate proof.

6) ARFF Charges for Non-Airside Call-Outs

IATA fully supports AsA's proposals to give back in the form of a rebate any revenues from non-airside call-outs. However, IATA considers that such rebates should be given to the users of the five locations (Sydney, Brisbane, Melbourne, Perth and Adelaide) that are currently overcharged in order to cross-subsidize the remaining 18 ARFF locations.

Part II: Level of charges proposals

1) Remarks on the completeness of information

It is important to highlight that AsA needs to provide users with enough information to allow users to formulate an informed opinion on the proposed charges.

AsA has provided some detailed financial information which has helped to initiate a debate on the charges proposals. However, there are two areas where more information is needed as it is key for a full assessment of AsA's proposals:

- Regulatory accounts: Given that AsA works under a dual till accounting, users should have been provided with historic financial information split by regulated and non-regulated accounts. These would have facilitated:
 - o A correct reconciliation between regulated/non-regulated accounts and the Audited accounts from the Annual reports.
 - o An understanding on how the "regulatory" asset base evolves (as the asset base in the audited accounts is subject to revaluations which are not allowed by the regulator). This is of particular importance given what is discussed in Part II Section 3.
 - o A correct understanding of how AsA performed against targets in previous agreements
 - o An identifiable base year for 2012-16 forecasts
- Benchmarking information: AsA has provided limited benchmarking information. It is not clear how efficient AsA is against comparable ANSPs. The importance of this is explained in more detail in Part II Section 2.

2) Building Block 1 – Operating costs

AsA is keen to show the gain in productivity since the beginning of the decade. To prove such point, the draft proposal indicates that charges would have improved by 40% (in real prices) since 2001.

Although such trend does show an overall level of improvement, it does not provide evidence on how efficient AsA is with respect to comparable ANS providers. It does not indicate how efficient it was in 2001 and neither how it will be in 2016. In other words, AsA is not making an in-depth analysis on how close it is to the efficiency frontier.

AsA has provided two charts³, one related to the IFR hours per en route controller and the other related to a benchmark of ATC employment costs. Unfortunately, IATA considers that the two charts are insufficient to justify the level of efficiencies pursued or being achieved by AsA.

The most flagrant flaw can be found in the benchmarking chart. AsA has not specified the criteria behind the chosen ANSP comparators. In order to construct an appropriate benchmarking exercise, it is important to choose "like-for-like" comparators. Two of the most important factors to take into account are the complexity of the airspace as well as any Purchasing Power Parity.

For instance, if AsA wanted to use Western European comparators, the company would need to choose those ANSPs with relatively less complex airspace⁴.

³ PCC Presentation on December 2010

The ACCC stated in its analysis of the LTPA 2005-09 that an appropriate benchmarking tool was needed in order to analyze the level of efficiency of AsA. Moreover, the ACCC indicated that such tools should be developed in conjunction with users. The same comment was made by the ACCC in its analysis of the 2003-04 charges.

Until now, AsA has not yet taken the necessary steps towards meeting the ACCC's recommendations.

As such, there is not enough information to make an informed comment on the level of operating costs. Until such benchmarking is constructed, AsA should keep its operating costs constant (in nominal terms) throughout the period.

3) **Building Block 2: Depreciation**

a) **Allowed depreciation on LTPA 2005-09 versus actual depreciation**

During the 2005-09 period, AsA was allowed, on average, some AUD 77 million per year on depreciation charges. However, actual figures (sourced from the audited accounts) show that between the financial years 2004-05 to 2008-09 the level of depreciation was AUD 59 million (note that this covers regulated and any other commercial related assets). This implies that AsA received some AUD 92 million of excess revenue during the 2005-09 period. This is shown in table 5.

Table 5: Forecast depreciation LTPA 2005-09 and actual depreciation from the AsA's annual reports

AUD million	2002-03	2003-04	2005	2006	2007	2008	2009	Total
LTPA 2005-09			77.1 m	74.4 m	76.8 m	78.6 m	78.3 m	385.2 m
Actuals (Annual reports) ⁵	47.6 m (2002-03)	72.2 m (2003-04)	64.4 m (2004-05)	53.1 m (2005-06)	52.1 m (2006-07)	62.0 m (2007-08)	61.5 m (2008-09)	293.0 m
Difference								92.2 m

In addition to the above, the calculated asset base for the 2011-16 period will be overestimated, and the company will therefore earn a double counting (as depreciation will be recognized twice for the same assets). Moreover, the overestimated asset base will allow AsA to earn a higher return (in value)⁶.

IATA will not support any double counting of charges. AsA should recalculate its 2011-12 opening asset base taking into account the allowed for depreciation in the LTPA 2005-09.

b) **Forecast depreciation and capital expenditure**

Depreciation is forecast to increase to AUD 144 million by 2016. This is almost double the allowed depreciation rate during the LTPA of 2005-09. The increased levels of depreciation are a direct consequence of the significant levels of forecast capital expenditure over the forecast

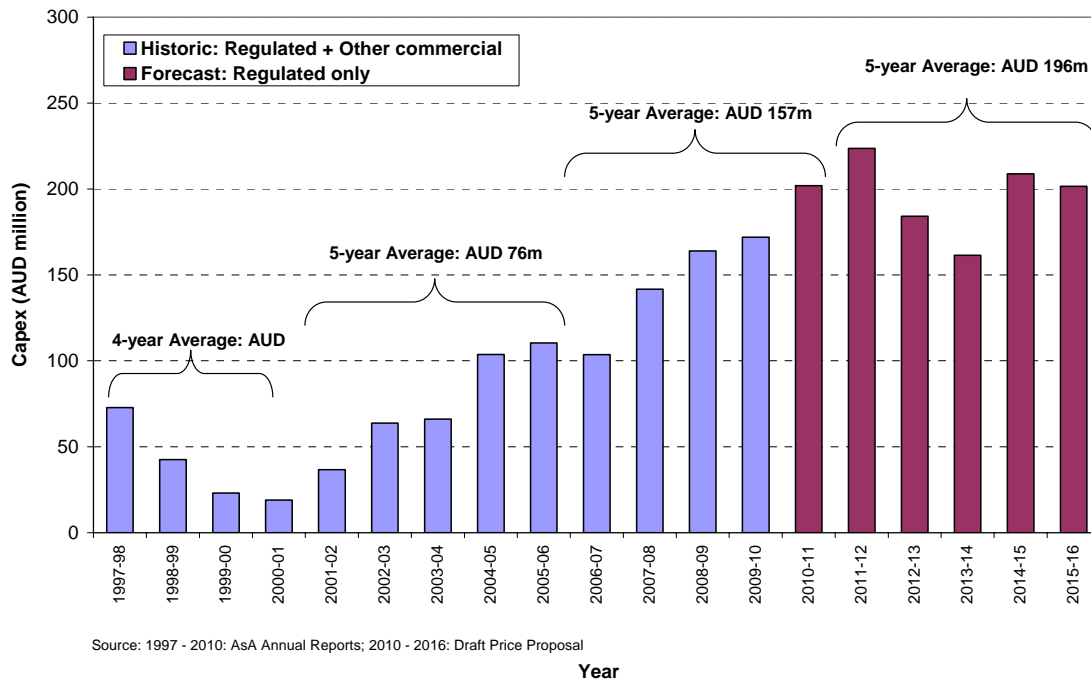
⁴ The only Western European countries with relatively lower airspace complexity are the Nordic countries (Finland, Norway and Sweden) as well as Ireland. European states with the highest traffic complexity include UK, Belgium, Netherlands, Switzerland, and Germany. Source: Eurocontrol – ATM Cost-Effectiveness 2008 report.

⁵ There is a timing mismatch between the LTPA (calendar year) and the annual reports (financial year). The table uses the Jul 2004- June 2009 period as comparator. Had the Jul 2005 -June 2010 period been used as comparator, the overall difference between the annual reports depreciation and the LTPA depreciation is AUD 80 million. Still, this is a considerable high amount.

⁶ Based on the historic depreciation levels, it appears that the differences have been generated by changes in asset lives rather than a delay in the capital investment program.

years, which are substantially higher than that made historically. Figure 4 compares the historic AsA annual capital expenditure since 1997 and the forecast until 2016.

Figure 4: AsA historic and forecast capital expenditure 1997-2016



Considering that AsA’s gross value of assets (revalued) as of June 2010 is AUD 953 million⁷, AsA’s capital expenditure renewals for the period July 2011 to June 2016 (AUD 539 million) will replace more than 55% of these assets in just five years⁸. This suggests an unusually small lifetime for ANS assets. AsA should review its capital expenditure program and seek for areas where capital expenditure can be delayed.

AsA’s listing for capital expenditure is presented item by item but there is no justification associated. Similar items can appear in several sections with no apparent linkage and it is difficult to track development programs against the capex. The justification for refurbishment of items such as NDBs in particular needs to be supported as they represent a significant cost with limited benefit. The capex program needs to be presented in such a form so that the need and benefit is clearly identified and supported.

Such listing includes a single line called “ATM Future Systems project” for AUD 191 million⁹. There is the need for more transparency on the calculations behind such large capital investment, as this project alone represents some 20% of the overall program.

Moreover, given the large uncertainty in this project, IATA proposes to remove altogether from the capital expenditure program until there is much better certainty on the numbers involved (budgets, timing, etc). IATA also suggests the two following charging arrangements:

- Alternative 1: Set the LTPA from 2011 to 2015 (i.e. 4 years instead of 5). This would allow having better information for setting pricing in the following LTPA (i.e. 2015-19) instead of incorporating an unknown figure for 2015-16 in a 5-year agreement.

⁷ Land, Buildings, Plant, Equipment and Intangibles

⁸ This calculation is not counting any renewal expenditure in 2010-11 as the amount was not available, nor does it take into account that most of the capital expenditure in the 2005-09 period was mainly on asset renewals

⁹ The second biggest item is AUD 58.2 million (significantly below the “ATM Future systems” investment)

- Alternative 2: Set the 5-year LTPA 2011-16 charges levels without any “ATM Future Systems” investment. Once numbers are better known, then an adjustment to the agreed price level can be negotiated. Such adjustment would solely relate to the investment on this ATM project.

c) Forecast depreciation, asset base and asset lives.

Another issue to highlight is the increase is the differential between the rate of increase of depreciation versus the rate of increase of the asset base. Table 6 compares such rates for each service for the period 2012-13 to 2015-16.

Table 6: Growth in asset base levels compared to depreciation levels 2012 - 2016

	2011-12	2015-16	Growth
Average asset base			
Terminal	AUD 393.5 m	AUD 470.5	19.3%
ARFF	AUD 152.1 m	AUD 194.6	27.9%
En route	AUD 392.1 m	AUD 561.9	43.3%
Depreciation			
Terminal	AUD 37.1 m	AUD 56.7	52.6%
ARFF	AUD 11.5 m	AUD 19.6	70.8%
En route	AUD 43.8 m	AUD 67.8	54.8%

It can be seen that particularly for Terminal and ARFF services the level of depreciation increases in 2.7x and 2.5x times (respectively) compared to the rate of increase in their asset base. This implies that life of the assets being added to the base is substantially lower than the average life of the existing assets.

AsA should provide more information on the asset life assumed in its forecasts.

4) Building Block 3: Return on capital

AsA forecast its return on capital to increase from AUD 88 million in 2011-12 to AUD 115 million in 2015-16. Such forecast is significantly higher than that calculated over the 2005-09 period (between AUD 39 million to AUD 52 million). Such increase is mainly driven by the large-scale capital expenditure as well as the increased WACC for the new period.

IATA has already expressed its reservations to the capital expenditure and its influence on the asset base, and will therefore not repeat the issue.

IATA considers that AsA should adjust the following assumptions in its WACC calculations.

- Risk free rate: AsA should use the 5-year government bond rate instead of the 10-year one. This is due to the fact that the price agreement is 5-year in length¹⁰.

It should be noted that the PwC report prepared for AsA’s 2005 LTPA coincided with this approach.

- Debt margin: IATA does not support AsA’s claim for a debt premium of 2.3%.

¹⁰ Moreover, the risk free and debt margin assumptions are based on the most recent data and not historical averages. For instance, the ACCC used a 10-day average when setting the WACC for the 2005 LTPA.

AsA indicates it used a AA credit rating as the benchmark for setting the debt margin. However, the ACCC's debt margin assumption for the 2005 LTPA was based AsA's actual credit rating, which was and still is AAA. There is no justification to change such assumption.

- **Gearing:** AsA assumes a 45% gearing in its calculations. However, as of June 2010, AsA's gearing was already at 49%¹¹ (and probably increasing due to the large forecast capital program). Moreover, the typical capital structure adopted by regulators is between 50% and 60%. As such, AsA should therefore consider using a higher gearing level, such as 55%.

Moreover, there appears to be an inconsistency between the cost of debt being requested by AsA (7.38%) and the actual debt being paid by the company. Table 6 shows AsA's debt position as of June 2010. Such position includes the emission of long-term bonds that pay significantly lower interest rates.

Table 6: AsA debt position as of June 2010

	Amount	Issuance date	Maturity	Interest rate
Bond	AUD 99.54 m	Nov 2006	May 2011	6.1% ¹²
Bond	AUD 148.9 m	May 2009	Nov 2014	5.8%
Commercial Papers	AUD 44.8 m		Less than a year	4.7%
Total	AUD 248.4 mm			

Source: AsA Annual report 2009-10

Although it can be expected that interest rates will be higher for the renewal of short-term debt (i.e. the commercial papers) and the AUD 100m bond emission expiring in 2011, AsA will still pay around 5.8% for its AUD 150 million bond that will only expire in May 2014. This bond currently represents 50% of the current level of debt.

As such, allowing a 7.38% to the entire geared portion of the asset base would provide AsA with an unacceptable windfall income, which bears no relation to its current position. AsA needs to make the necessary corrections to reflect this situation.

5) Timing in the forecast costs on new services

AsA is including costs on services for new locations that "might" or "might not" materialize. For instance, the forecast ARFF building block costs include an additional AUD 7.2 million in year 2011-12 due to the potential implementation of two new ARFF services (this implies that these two new locations should be up and running by 1 July 2011, which does not seem to be the case). Additional "Projected" regulatory changes have also been included for a ARFF category upgrade at Perth as well as ATC tower upgrades at 11 regional airports (It is not clear the effect on the building blocks of the Perth and ATC projects on a yearly basis. AsA should provide such information).

Users note that AsA has stated that it would give back projected projects that do not materialize. However, this practice involves timing issues (users today are not the same as users tomorrow). As such, it might be the case that users will end up paying more (or less) charges compared to what receive in rebates. Moreover, given the different types of cross subsidies being applied

¹¹ Calculated as total interest bearing debt / Equity. Numbers for the calculation were sourced from AsA's 2009-10 Annual Report.

¹² This amount has been calculated internally. AsA's 2010 annual report indicates that the average debt for the two bond emissions is 5.99%. A previous annual report (2008), which reported only the older bond, indicated that the average rate for that bond was 6.14%. By default, the average rate for the newer bond should be around 5.8% in order to match the average interest rate of 5.99%.

across AsA (i.e. among services, among locations and among types of users within that location), it will not be clear to identify which user should be receiving a rebate.

Rather than “factor in” such contingency costs in the price agreement ex-ante and give them back to users (if these do not materialize), AsA should conduct a specific consultation on charges if there were regulatory changes during the period. In order to maintain the adequate incentives for outperformance, changes in charges should only reflect the impact of these services and not be adjusted by any other updated cost information.

6) Traffic

AsA approach to outsource traffic forecasts to a third party is welcome. It should be mentioned that IATA charge's area (an IATA core department) bears no influence on IATA Consulting (the commercial arm of IATA).

Forecasts have been constructed with the aid of econometric modeling. Within this, two important explanatory variables are the Australian and Worldwide GDP. The traffic report was based on GDP forecasts made on July 2010. Should there be a significant variation between these and more recent forecasts, then traffic assumptions should be adjusted.

Part III: Other proposals

1) Risk Sharing agreements

a) Revenue Sharing

The current revenue sharing proposals are the most adequate given the current stakeholder positions.

b) Capex risk sharing

The principles behind the capex risk sharing are clear: if the ANSP does not deliver its capital expenditure, it should give back any allowed excess depreciation and cost of capital over the period. If the capital expenditure program does not go as planned then there should be a trigger for providing rebates to users. Triggers that prompt rebates if the capital expenditure is different than expected are welcome. However, two issues arise:

- The percentages are too big and provide a perverse incentive to delay capital expenditure. Delays mean that AsA would benefit from cost of capital and depreciation originally allowed in the building blocks for investments it did not make on the forecast year¹³.

Moreover, in the first year AsA is only proposing a 50% threshold and not applying the cumulative 25%. Given that AsA's biggest investment is in year 1 (some AUD 220 million), any delay would provide a significant benefit to AsA.

Users expect that at the least, the first year capex should also be capped at 25% (and not at 50%).

- This capex sharing arrangement should be without prejudice to any necessary adjustments at the end of the period. Following the logic explained above, any portion of undelivered capital expenditure, even if it is lower than the proposed threshold of 25%, will imply that the ANSP would have received revenue over the period to cover alleged costs (depreciation and cost of capital) that it never incurred

For example, if the capital expenditure is consistently 15% below than forecast for every year, this implies that the level of depreciation and cost of capital attributed to the company due to the new capital expenditure will be around 18% higher than what it should be. Assuming that the lower capex is not related to efficiency gains (i.e. outperformance), then users should be given back the allowed revenues for costs the ANSP never incurred.

In summary, AsA should confirm that the sharing arrangement does not dismiss potential user's claims on the overall delivery of the capital expenditure program at the end of the period.

¹³ Although it could be claimed that delays might be accepted as long as the level of service is maintained, it is not clear that the Service Charter is detailed enough to ensure such monitoring.

2) Service charter

IATA welcomes the introduction of Service Charter (or commonly known as a Service Level agreement). Such agreements should guarantee users with a set of performance targets for a number of agreed critical performance indicators

Although IATA recognizes that this charter is still a “work in progress”, there two important elements that are missing:

- Although the charter includes a number of service targets, it does not clarify what would happen if such targets are not met. Users should be financially compensated if these are not met. Otherwise, AsA would have a perverse incentive to meet its cost targets by reducing the level of service
- As mentioned previously, there needs to be a clear link between the proposed capital expenditure and the targets being proposed in the charter. In other words, such exercise will provide the appropriate justification on why the capital expenditure is needed in the first place, and allow users to quantify and make an informed decision on the “trade-off” between higher costs and higher levels of service.

Without these key additions, the charter would not provide AsA with the adequate incentives to meet the service targets.

IATA looks forward to work with AsA in developing such additions in the near future.
