



SUBMISSION

TO

Airservices Australia

Review

ON

**AIRSERVICES AUSTRALIA'S
FIVE YEAR PRICING PROPOSAL**

10 February 2011



Commercial in Confidence

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Executive summary

The Qantas Group (comprised of Qantas, Jetstar and QantasLink) operates in all of the major commercial airline markets in Australia, providing international, domestic, regional, freight and charter services. We are therefore well positioned to understand the drivers and issues in each of these markets. The Group understands the challenges that Airservices Australia (AsA) faces in determining costs and proposing prices which are acceptable to the Minister, the industry and that are endorsed by the Australian Competition and Consumer Commission (ACCC).

The proposed Long Term Pricing Agreement (LTPA) and associated 'Services Charter' demonstrate a continuing commitment to customer service and this approach is most welcome. The Group understands the challenges and the great efforts that AsA have gone through to establish a balanced approach and the difficulty associated with trying to "future proof" a dynamic industry that has many variables.

In light of the challenges associated with meeting the disparate needs of a range of stakeholders it is not surprising that the LTPA has not seen a significant departure from the existing AsA price structure and methodology.

Consequently the Qantas Group is of the view that the proposed long term pricing agreement if implemented in its current form disadvantages regional services, in particular it will significantly disadvantage the continued growth and development of air services to many destinations in regional Australia. The proposal will actively encourage airlines to increasingly shift capacity away from regional markets and increase their focus on major gateways. As a result the associated tourism and economic benefits to regional markets will diminish. The proposed pricing proposal will result in increasing average air fares and dampening travel demand on many city pair routes to and from regional markets.

Furthermore it should also be noted that from an economic perspective it is the Qantas Group's view that the LTPA may not achieve AsA's three pricing objectives, notably to set prices that will:

- provide pricing certainty and support aviation industry investments;
- enable the right investment at the right time; and
- improve the efficiency of service delivery by AsA and the industry.

The Qantas Group has arrived at this view because we believe that there are a number of considerations that are either overlooked by the AsA, or acknowledged but not used in a quantitative sense in the computation of charges. The Qantas Group also believes that this review provides a critical opportunity to challenge a number of the assumptions that underpin

the current charging methodology and to seek improvements in the equity and utility of the charges to airlines.

The Qantas Group's key concerns apply to all AsA proposed charges: Terminal Navigation (TN), Enroute (EN) and Airfield Rescue and Fire Fighting Service (ARFF) charges. Economic, activity and implications together with building block model concerns have been analysed in detail with specific reference to TN charges and these are contained in Appendix 1.

The concerns that the Qantas Group have with charges are as follows:

- **Terminal Navigation** – A significant negative impact on regional markets and destinations in Australia. In a number of ways the structure of the LTPA will lead to a wealth transfer (we estimate in the order of magnitude of approximately \$70M) from regional airport users to major capital city airport users. This in turn impacts negatively on price sensitive regional markets and has overall negative impacts for the Australian economy. The Group also believes the basin in Brisbane should be expanded to include the Gold Coast and Sunshine Coast and that the Melbourne basin should include Avalon.
- **Enroute Charges** – The Qantas Group acknowledges that in previous years EN charges have assisted in subsidising TN charges at regional airports and is concerned that the removal of cross subsidisations effectively increases regional charges to the point that it negatively affects activity demand and welfare in regional areas.
- **ARFF charges** – The Qantas Group considers that the overall rate of increase is unreasonably high (20% in first 2 years for category 6 aircraft, and 30% for the other categories) and will affect the demand and recovery of costs in a number of locations. We believe the rate of increase should be moderated in the first two years and that the costs for new ARFF services should not be introduced prior to their actual implementation.

The concerns that the Qantas Group has with passenger forecasts are as follows:

- **IATA's domestic and regional forecasts** are too low, with predictions of domestic passenger kilometres growing at an average rate of 4.9% between FY11 and FY16 and regional passenger kilometres to grow at 5.1% over the same time period. Based on historical growth rates, the Qantas Group believes that the growth rates will be significantly higher over this period. In the last 20 years the average historical growth rate in domestic RPKs has ranged between 6.0% and 8.3% and during this period a six year growth rate of 4.9% or less would have occurred on only three occasions.

- **International growth forecast** – The Group believes that the IATA international average air passenger forecast growth rate of 5.8% is in line with historical averages and therefore is reasonable.

The key total cost concerns that the Qantas Group has are as follows:

- **Circularity of the Building Block Model** – The Activity used to determine the unit price is at the same time driven by the unit price especially in price sensitive, elastic locations. A more complex methodology needs to be adopted that incorporates an estimate of both the airfare elasticity of demand and the extent to which an increase in unit costs can be passed through into higher airfares.
- The **Weighted Average Cost of Capital (WACC)** – The Group believes:
 - a. Debt margin of 230bp is unacceptably high. AsA is rated at AAA+ by Standard and Poor's and the appropriate funding rate for an AAA+ business should be between 40-50bp; and
 - b. Prefunding returning a full WACC rate which includes a return on equity and debt when the industry receives no benefit for the assets is unreasonable.
- **Capital expenditure programme** – The \$980m five year capital expenditure program includes a number of projects that lack sufficient transparency to validate the costs, benefits or specific aeronautical nature. This is unacceptable when passengers and airlines are asked to pay for these services without the ability to determine if they represent appropriate and prudent expenditure. Specifically, the capital expenditure program includes \$90m in medium and minor projects that need significant additional information to justify their inclusion. The Qantas Group would suggest that a separate ACCC approved pricing mechanism should be used to address such uncertain projects and services and that these costs should be excluded until the projects have been properly assessed, costed and agreed by all industry stakeholders.
- **Cost accountability and efficiency of project delivery** – The LTPA currently lacks a mechanism to ensure that there is accountability for the cost, progress and delivery of projects. Such a mechanism should be included to ensure that there is commercial accountability and rigour underpinning the capital expenditure program.
- **Potential new TN and ARFF services** – The inclusion of costs in the LTPA for potential and unconfirmed services such as ARFF category 10 in Brisbane & Perth and TN or ARFF services in Coffs Harbour, Port Hedland, Ballina and Gladstone is not acceptable. Currently there are no confirmed plans for category 10 aircraft services at Brisbane or Perth. Whilst forecasts tip the other four locations to achieve activity requiring ARFF or TN services sometime the next five years, the cost increase could in turn reduce the demand. The Group objects to paying for services prior to a confirmed and sustained requirement.

- **Prefunding of capital expenditure (CAPEX)** - The LTPA contains approximately \$200m of specifically identified prefunded works. Prefunding also occurs when projects are delayed or assets are prepurchased. Prefunding is not a generally accepted method of project funding and results in passengers and airlines paying a return on and a return of assets that they are not currently receiving any immediate benefit from.
- **Risk sharing mechanisms** in the LTPA need to be reviewed. The current mechanism is ineffective at preventing prefunding or fostering the appropriate sharing of activity risk.

Introduction

The Qantas Group acknowledges that one of the challenges faced by AsA in setting prices is that any increase in price is required to be assessed and approved by the ACCC. The ACCC process for review can be lengthy. This acts as an incentive for AsA to include all costs for potential projects or services in the capital expenditure profile to avoid the need for subsequent ACCC review during the term of the pricing agreement. The fundamental problem with this approach is that it results in high upfront prices for airlines which in turn leads to higher ticket prices. Higher ticket prices affect demand and therefore the current AsA pricing approach impacts the overall economic welfare of the travelling public and the broader Australian economy.

The costs for many locations increase dramatically in the first 2 years of the LTPA. For example TN charges increase by 6% in the first year then a further 4% in the second year. ARFFS charges increase by 10% year on year for the first 2 years for Category 6 and 15% year on year for the other categories. The Qantas Group estimates that the overall impact of this structural over-recovery for projects that may not proceed translates to a 2.6% total price impact over the life of the agreement or a \$9.3m increase in FY11 alone. Over the 5 year price period of the LTPA the total impact is approximately \$120m assuming no activity growth or aircraft fleet changes.

The Qantas Group believes that the LTPA charging should only take into account projects that have been fully reviewed, costed and approved. There should be a separate mechanism developed that would allow consultation on new projects to be discussed with airlines and included during the term of the LTPA at which time an adjustment of the charges would be appropriate. This approach would avoid the structure of over-charging found currently in the LTPA, which leads to unnecessarily high charges and the dampening of demand.

Welfare of regional Australia

The implications of the current structure of charges in the LTPA is that large capital city aerodromes (eg Sydney, Melbourne, Brisbane) will pay significantly lower charges than smaller capital city aerodromes (eg Adelaide, Hobart, Canberra), large regional aerodromes (eg Cairns, Sunshine Coast, Launceston, Mackay, Rockhampton, Alice Springs) and smaller regional aerodromes (eg Karratha, Coffs Harbour, Tamworth and Broome).

Charges for the relatively small aerodromes can be up to A\$10 per tonne higher than at the major capital city aerodromes. A cost differential of A\$10 per tonne manifests itself in airfare increases to these smaller markets. For example, the introduction of TN services in Broome and Karratha translates to passenger cost increases of \$8.40 and \$6.40 respectively per

arriving and departing passenger. This cost differential is sufficient enough to cause a notable shift in demand and viability of flights out of small aerodromes and into large aerodromes.

To the extent possible, an increase in Airservices charges may be passed-through into higher average airfares, which will lead to a reduction in air passenger demand. A reduction in air passenger demand will not only reduce the welfare of air travellers but it will also lead to a decrease in the consumption of complimentary tourism goods and services such as accommodation, food, beverages, fuel, retail shopping, gifts and souvenirs.

According to the June Quarter 2010 National Visitor Survey, in FY10 around 66m overnight domestic visitors spent \$43b at an average spend per visitor of \$650 plus 151m day visitors spent \$16b at an average spend per visitor of \$103. Around one quarter of all overnight visitors arrive at their destination by air transport and 1% of day visitors fly by air.

In many instances complementary industries represent a significant proportion of the economic activity in the relevant region. This is particularly true for smaller regions that have less diversified economic bases for example Cairns, the Gold Coast, Broome and the Sunshine Coast.

Airfare elasticities of demand

Elasticity is the parameter that is most pivotal to understanding the impact of higher charges on the economies of regional Australia as demand reduces in response to higher average airfares. A number of forces are likely to drive elasticity in particular route types, including the dominant purpose of travel (leisure, visiting friends and relatives or business); the strength of underlying demand along the route in question; and the level of the average airfare. These forces are likely to differ across routes, generating quite different elasticity outcomes.

The Qantas Group's empirical estimates of the airfare elasticity of demand across a wide variety of domestic city-pairs confirms that demand is significantly more elastic at combinations of small aerodromes than at combinations of large aerodromes. The airfare elasticity of domestic demand of large major city aerodromes is just over 3 times less elastic than that of smaller major city and minor city aerodromes and almost 6 times less elastic than that of regional aerodromes.

The elasticity findings in Appendix 1 suggests that not only will air passenger demand at small aerodromes fall by more than they will at large aerodromes because charges are higher, but also because demand is significantly more sensitive to the average airfare at small aerodromes.

On page 13 of its March 2010 discussion paper entitled "Terminal Navigation Pricing Review: Discussion Paper", the AsA make the following observation:



In the same paper the ACCC referred to a Productivity Commission report that argued large airports may have demand that is less price sensitive than smaller airports. However, Airservices is unaware of any robust evidence that this is the case, and as noted above, even if this is the case, what magnitude of differences there might be across airports is hard to quantify.

Robust evidence is available to show that large aerodromes are characterised by demand that is significantly less elastic to average airfares than small aerodromes. The assumption under the LTPA is that demand is inelastic and that price will not affect demand. In reality, the elasticity in the non major ports has a significant impact on the demand for flights and consumption of complementary tourism services. The demand growth and regional welfare impact makes it essential that the AsA reconsider its approach to computing prices.

The Qantas Group maintains its belief that the hybrid framework for TN pricing outlined in detail in its June 2010 submission is likely to generate the maximum possible welfare outcome for the impacted parties since any consumption distortions and flow-on economic impacts will be minimised. A similar methodology should also be adopted for ARFF charges as well.

The Qantas Group has used the aerodrome elasticity information to quantify two important effects of AsA's proposed charges compared to the Qantas Group's proposed charges:

- the welfare of air passengers by aerodrome; and
- the tourism spending within the tourism catchment of the relevant aerodrome.

Air passenger welfare

The Qantas Group believes that air passenger welfare, as measured by consumer surplus, at small aerodromes will be around \$70 million lower under the LTPA than under its alternative proposal. Consumer surplus is equal to the maximum airfare that any one air passenger is willing to pay less the average airfare that is actually paid, scaled-up by the volume of air passengers that actually travel by air.

The aerodromes that appear most adversely affected by AsA's proposed TN charges are Adelaide at -\$14m followed by Perth (-\$12m), Cairns (-\$12), Canberra (-\$7m) and Coolangatta (-\$5m). The aerodromes that stand to benefit from the AsA proposal over the Groups proposal are Sydney (+\$58m), Melbourne (+\$12m) and Darwin (+\$1m). Air passengers that are most adversely affected are predominantly those that use regional, minor city and smaller major city aerodromes. The LTPA effectively involves a transfer of around \$70m of air passenger welfare from these aerodromes to Sydney and Melbourne.

Visitor spending

The Qantas Group estimates that visitor spending in catchment areas that are proximate to small aerodromes, and the flow-on benefits that this spending generates, will be lower under the LTPA than under the Qantas Group proposal by \$190m. The impact on different regions is detailed in Appendix 1.

Cross price effects on demand

A larger increase in charges at smaller capital city and regional aerodromes than at large capital city aerodromes will see some substitution of flights out of the small capital city and regional aerodromes and into the large capital city aerodromes. Where such substitution is possible, due to demand and supply side characteristics which are explained below.

Demand-side substitution occurs when consumers respond to relative price signals by consuming more of the relatively cheaper product and less of the relatively more expensive product. In the context of the proposed price changes, the demand-side substitution involves consumers reacting to the relatively higher average airfares at smaller aerodromes compared to large major city aerodromes. There are two types, of switching: destination and, where possible, aerodrome switching.

Destination switching occurs when a particular holiday or weekend destination has become more expensive than another and so the holiday maker decides to switch holiday destinations. Air passengers will holiday more at, or visit, destinations that involve predominantly large aerodromes and less at destinations that involve predominantly small aerodromes. The extent of the destination switch will depend on the proportion of leisure traffic and the price differential. This means we should expect much higher leisure traffic proportions for those destinations subject to the highest charges, particularly for the 'pure' leisure destinations such as Cairns, Gold Coast, Sunshine Coast, Broome and Hamilton Island.

Aerodrome switching occurs where one aerodrome has become more expensive than another nearby aerodrome, resulting in the air passenger switching airports. Air passengers will switch their travel from small, more expensive aerodromes to larger, less expensive aerodromes where the aerodromes are relatively proximate. It mainly depends on the distance between airports, and the price differential.

There appear to be at least two examples of areas in which there is strong substitution between airports that are in close proximity – South East Queensland (notably Brisbane, Gold Coast, Sunshine Coast and Ballina airports); and Melbourne (notably Tullamarine and Avalon Airports).

Cross price effects on supply

The single most important driver of passenger volume at airports is the capacity decisions of airlines. A pricing framework that raises the costs associated with flying passengers to small

aerodromes relative to large major city aerodromes will result in more capacity being allocated to large aerodromes at the expense of small aerodromes.

The Qantas Group estimates that in a rational market, a charge that is \$10 per passenger higher than would be the case using another pricing framework will reduce capacity by between 3% and 10%. Given the close correlation between passenger volumes and capacity, we would expect that passenger volumes will fall by similar magnitudes. This will not only affect consumers but it will also affect the profitability of aerodromes themselves and the ability of small aerodromes to compete with larger aerodromes. Given the economies of scale that prevail in the airport business, any Government regulatory change that reduces the ability to achieve scale will be damaging to unit cost and thus damaging to the ability of the small aerodromes to remain viable.

Australian current account impacts

The impact of raising charges, especially by a larger amount at relatively small major city and regional airports, will result in higher domestic leisure airfares compared to international leisure airfares. This in turn may result in passengers choosing international outbound leisure travel in place of domestic leisure travel. Substitution of this type will result in a reduction in domestic tourism consumption and an increase in overseas tourism. This effect is compounded by the strengthening of the Australian dollar. This substitution not only affects the economic activity and employment of regional Australia but also the country's balance on current account.

Mode of transport

Increasing prices could easily make passengers turn to other forms of transport apart from air transport (e.g. road, boat or train) where such substitutable services exist. For example, Sydney residents who once flew north to Coffs Harbour, the Gold Coast and the Sunshine Coast may now decide to drive instead. Melbourne residents who currently fly to Adelaide or Hobart may decide to drive or ferry the 725km or 429kms respectively. Business travellers who currently fly to Canberra and other regional centres such as Albury and Tamworth may now decide to travel by car. There may also be a combination of destination and transport substitution. For example, Perth residents wishing to spend some time at Cable Beach in Broome may now decide to drive to Margaret River.

Terminal Navigation charges

Terminal Navigation charges were subject to a review in mid 2010 where seven options were proposed by AsA ranging between location specific and network charges. The current pricing is mostly location specific with some pooling of costs where basins exist. Qantas proposed an option which would maximise the welfare benefit. The proposed TN prices differ only marginally from the current location specific approach.

The Qantas Group, in the response to the Terminal Navigation options review, proposed a two part tariff where the variable costs are recovered under a location specific model and the fixed costs are networked across the segments. The variable cost component satisfies the user pay and thus equity principles, to finance the costs that are directly associated with their supply decisions and drives efficiencies. Applying a network model for fixed terminal navigation costs recognises the lumpy infrastructure costs and overheads that are part of a complete national service simultaneously minimising the adverse impact on consumption of terminal navigation charges at smaller aerodromes. The activity driver was also shifted from pure MTOW towards movements.

Considering the above economic basis and the evidence detailed in Appendix 1, Qantas recommends that the TN charges to be reviewed to maximise the economic benefit to the industry and the Australian economy.

Basin pricing

The Qantas Group believes that, as a result of demand switching from smaller aerodromes to larger aerodromes as described above, Sunshine Coast and Gold Coast airports should be considered to be in the same basin as Brisbane airport, and Avalon airport should be considered to be in the same basin as Tullamarine. If these aerodromes are not considered to be in the same basin, then relatively low TN charges at Brisbane and Tullamarine airports will lead to demand switching from Sunshine Coast and Gold Coast into Brisbane and from Avalon into Tullamarine. Empirical evidence suggests that these aerodrome demand switching effects are both statistically significant and material.

A second operational reason for believing that Sunshine Coast and the Gold Coast should be part of a Brisbane (or South East Queensland) basin and that Avalon should be part of a Melbourne basin is that they share common costs; in particular, they share common AsA services. Specifically, flights into and out of Gold Coast and Sunshine Coast frequently use Brisbane radar and class D tower services and vice-versa, while flights into and out of Avalon frequently use Melbourne radar and class D tower services.

Enroute charges

The Qantas Group acknowledges the consideration made in the LTPA regarding the capping the TN charge at a number of regional airports and subsidising capped airports via Enroute charges. The Qantas Group believes this should continue as many Enroute services are also services that benefit from the regional class D towers currently costed under the TN charges.

The Qantas Group also supports retaining the current simplicity of charging for Enroute charges. We would not like to see a situation whereby the removal of cross subsidisation

effectively increases overall regional charges to the point that it negatively affects demand and the reduction in recovered revenue exceeds the value of the cross subsidisation.

The Qantas Group would support a shift towards Enroute charges based on the level of airspace and the services provided. We understand this will require significant technological advances and mandates for the use of Global Navigation Satellite System (GNSS) and Automatic Dependant Surveillance Broadcast (ADS-B) technology, particularly in upper airspace as opposed to the infrastructure intensive radar system and legacy navigation system.

ARFF charges

In the LTPA, ARFFS charges increase by 10% year on year for the first 2 years for Category 6 and 15% year on year for the other categories. The major drivers of these cost increases from July 2011 are new services and buildings. AsA has priced in two possible new services and estimate up to four new services will be required due to the forecast activity in each of Coffs Harbour, Port Hedland, Ballina and Gladstone.

The Qantas Group considers that the rate of increase is very significant and will affect the demand and recovery of costs in a number of locations. The steep increase in the first two years should be moderated and services reviewed to ensure that demand is not affected by higher prices. The costs for new ARFF services should not be introduced prior to their actual implementation. This amounts to a prefunding of these services from which neither passengers nor airlines derive a benefit.

The plan to introduce a call out fee for non aeronautical services is supported where it is competitive for the market to use ARFFS and to the extent that it does not disrupt the availability of the airfield. The Group also supports the proposal to rebate the revenue from these call-outs to airlines.

The Group would like to see more initiatives where fire fighting staff are utilised to improve the efficiency and functionality of the AsA. For example, that fire fighting staff become multi skilled and perform complementary Airport, Airservices or community functions which are flexible enough to not compromise CASA and airfield requirements. These could include functions such as conducting training courses for occupational health and safety, first aid, fire fighting, performing safety inspections, audits, security or office based project work.

IATA activity driver forecasts

AsA has commissioned IATA to forecast domestic, international and regional activity variables that are important inputs into the Building Block approach in determining charges. These forecasts extend out to FY16.

The Qantas Group is concerned that IATA's domestic and regional forecasts are too low, will artificially inflate the charge and will affect demand. IATA forecasts domestic passenger kilometres to grow at an average rate of 4.9% between FY11 and FY16 and regional passenger kilometres to grow at 5.1% over the same time period.

Domestic

The average historical growth rate for domestic revenue passenger kilometres (RPKs) depends on the time horizon chosen and the method used to generate those growth rates. Using 25, 10 and 6 year horizons and three different computational techniques¹, the average historical growth rate in domestic RPKs ranges between 6.0% and 8.3%. Relative to these historical growth rates, IATA's average growth rate is unusually low. A six year growth rate of 4.9% or less would have occurred on only three occasions over the past 20 years.

It is the Qantas Group's view that using the airfare as a driver variable of forecasts is flawed and the forecast decline in airfares that is used to generate these results is excessive and very unlikely over a six year horizon. The Qantas Group believes that a theoretically and empirically superior technique for generating forecasts of aviation passenger volumes is to take advantage of the strong correlation between passenger volumes and airline capacity. There is a very strong correlation between domestic available seat kilometres (ASKs) and RPKs. By accurately forecasting airline capacity, it is possible to generate reasonably accurate forecasts of passenger volumes.

There are likely to be a number of causal drivers of domestic RPKs that have shaped the historical growth in domestic market ASKs over the past two decades including:

- entry and exit from the market (eg Ansett, Virgin Blue and Jetstar);
- other supply disruptions (eg pilot and engineering strikes);
- movement in marginal cost, particularly unit fuel costs; and
- expectations about the economy and thus underlying demand.

The Qantas Group forecasts that ASK growth will average 7.0% between FY11 and FY16, rising steadily for the first three years, and peaking in FY14 at 9.7% before falling for the subsequent 2 years. These ASK growth forecasts imply that average RPK growth over the next 6 years will be 7.2%, with a time profile similar to that of forecast ASK growth. This average growth rate is more aligned with historical averages and is 2.3 percentage points above that forecast by IATA.

¹ The 3 methods used are a simple arithmetic average of annual growth rates, the median of those growth rates and a regression-based CAGR approach.

The Qantas Group believes that a domestic air passenger forecast of 7.2% over the next 6 years can be more rigorously defended than a forecast of 4.9% and as such should be used for the purpose of determining charges.

Regional

IATA forecasts that regional RPKs will grow on average by 5.1% pa over the next 6 years. This compares to historical average growth rates that range between 2.8% and 12.1%.

IATA's forecasts are based on placing all weight on the historical growth rate observed following the collapse of Ansett (2001), and placing no weight on the pre-collapse period which saw average growth that was over twice this pace. IATA's forecasts are built by assuming a passenger volume to GDP elasticity of 1.6 for which no rationale is presented. The Qantas Group believes that IATA's modelling approach and forecast outcome are inaccurate. While there was a supply-side structural change in early 2000, this doesn't mean that the 15 year information set prior to the change should be abandoned. If this 15 year information set is used, we see that ASK growth explains around 94% of the variation in RPKs. Like domestic RPKs, it is necessary to understand airline ASK decisions going forward if we are to understand future RPKs in the regional space.

The model developed and used by the Qantas Group estimates that average ASK growth in the regional sector over the next 6 years will average 11%. This in turn generates a RPK forecast that averages 12.1% over the same time period.

From an economics perspective, the Group believes that this very strong regional forecast is supported by expectations of strong commodity prices over the next 6 years and beyond, which in turn drives strong mining investment and production and therefore increased air travel requirements.

International

IATA presents its international passenger forecasts on page 35 of the IATA Report. The average growth rate forecast for international passengers between FY11 and FY16 is 5.8%. This is in line with historical central growth rates for international passengers. IATA's forecast average growth rate for international is in line with historical averages. The Group believes that this forecast average growth rate is reasonable, although history and statistical modelling suggests the time profile of growth may be different to that forecast by IATA, which says that growth will fall to 5.7% then rise to 6.2% before flat-lining at 5.7% for the remaining forecast period.

Circularity of the LTPA Building Block approach

The LTPA uses an ACCC endorsed Building Block model that calculates the allowable revenue to be recovered in one year from a return on assets (existing and new capital expenditure, less depreciation) using a WACC, plus a return of assets (depreciation) and operational expenditure. The total allowable revenue is then allocated by service or location then divided by the activity driver to determine a unit rate.

Under the building block approach, prices are determined using the following formula:

$$\text{Building Block Price} = \frac{\text{Allowable Revenue}}{\text{Activity Driver}}$$

The circularity argument says the following: an increase in charges increases the unit cost of airlines, which is passed-through into higher average airfares where possible given the different market characteristics on each route. Higher average airfares dampen demand or the activity driver. The activity driver, however, is in the denominator of the equation that is used to compute the unit charge, and so if the charge increases it follows that an increase in the unit charge actually causes an increase in that charge.

To circuit-break this circularity, a more complex methodology that incorporates an estimate of both the airfare elasticity of demand and the extent to which an increase in unit costs is passed-through into higher airfares is required. Without consideration of these parameters and the use of an appropriate pricing formula (as outlined in more detail in Appendix 1 of this submission) it is unlikely that the charges proposed by AsA will fully recover costs.

The Qantas Group considers that the LTPA Building Block methodology places regional communities at a disadvantage in comparison to their major city counterparts. The Qantas Group believes there is an alternative pricing model that, if adopted, would provide a more equitable allocation of resources across the Australian population.

Rate of return - weighted average cost of capital (WACC)

AsA is rated "AAA/Stable/A-1+" by Standard and Poor's (S&P). As a regulated monopoly Government agency AsA has a 'Critical Role' in providing civil and military air traffic control, which is of strategic importance to Australia's economy, public safety and defence capability. AsA has a legislated monopoly position for Australia's air-traffic control and aviation rescue and fire fighting (ARFF). S&P have the view that it is 'almost certain' that the Australian Government would provide timely and sufficient extraordinary support to AsA in the event of financial distress, in accordance with the S&P criteria for government-related entities².

² (GREs; see "Enhanced Methodology and Assumptions For Rating Government-Related Entities," published to Ratings Direct on June 29, 2009).

S&P view AsA's role as falling within the 'Critical' rather than 'Very Important' category following a review of its services and peers. In addition, the view is based on AsA's 'Integral Link' to its sole owner, given the importance of the AsA's operational role (including the politically visible nature of its public safety role), the strong degree of Government oversight (including the authority's strategic direction) and the Government's aviation policy (which indicates that services relating to control tower and ARFF will not be contestable). S&P also note that neither the current Government nor the federal opposition has a policy to privatise AsA.

The proposed AsA debt margin of 230 basis points (bp) above the risk free rate is unacceptably high. It is based on a stand alone rating of AA and recent regulatory decisions for other unrelated industries such as Australia Post with contestable services. The previous ACCC decision for AsA in 2004 was for AAA+ and 55bp, on this basis the debt margin should be reviewed. The Qantas Group strongly believes that a better proxy would be the Australian Government credit default swap pricing which is currently at around 40-50bp for five years.

Capital expenditure review

The LTPA proposes an ambitious \$980 million capital expenditure (Capex) plan with a significant portion of this expenditure in 2011 and 2012. Capex is the main driver of increased costs and prices in the first two years of the LTPA.

The Qantas Group appreciates that there are considerable capital expenses associated with the provision of a safe and modern system of air traffic management services. Capital expenditure projects are often determined by regulations and legislation as well as on the basis of safety risk assessments. However, the LTPA contains a significant number of projects regarding which the Qantas Group is unsure of their benefit or relevance to aeronautical services or that have not been explained in sufficient detail to allow proper assessment and endorsement. Considering the quantum of capital in the LTPA, it is critical that airlines are provided with detailed information about the cost, timing and benefits of each project to ensure that this expenditure is reasonable.

It is envisaged that any existing and new proposals would be costed in full from end to end and coupled with a complete business case that demonstrates the benefit to industry. This should apply to all projects within the term of the LTPA. One clear example requiring significant additional information is 'The Advanced Australian Air Traffic System' (TAAATS). This project will cost almost \$200 million during the LTPA. However, based on the historical cost of TAAATS, it is unclear if there may be another several hundred million dollars required to complete the project. Clearly this is a significant project requiring a significant sum of money. The Qantas Group would need considerable information and strong reasons to support this level of expenditure.

The Qantas Group also believes that a number of items in years 2013 to 2016 of the LTPA should be reviewed during the term of the LTPA to ensure that they are still relevant. There is risk associated with a five year agreement that once capital plans are agreed they become an expected outcome even if they may no longer be relevant. With the pace of technology change, in three or four years time projects may no longer be the best available choice for the industry. In line with the Services Charter, this pace of change highlights the need for a dynamic process to support a mechanism to adjust the LTPA during its term.

AsA projects also should shift towards industry solutions, where collectively industry can set the architecture and participate in software solutions; otherwise the industry will inefficiently continue to duplicate expenditure.

Contained in Appendix 2 is a list of projects that the Group believes should be carefully reviewed and justified prior to being included in the LTPA. For this reason we request further information on a number of items listed.

Radar direction

One project of particular concern is the introduction of approach radar control services at ten regional locations. The Qantas group is particularly concerned that the proposed project, which costs in excess of \$90 million, is lacking the necessary efficiency or safety benefits to justify it proceeding. The proposed project stems from Ministerial Directive 2004-4 which, despite being in existence since 2004, has not been implemented as there appear to be significant doubts as to the benefits of the project.

On 9 August 2006, the Chairman of the AsA Board of Directors advised the then Minister of Transport and Regional Services that as ‘... the cost of radars could not be justified on safety grounds, the 2004 Direction should be revoked.’ This advice has subsequently been repeated. On 23 March 2007, the Minister of Transport and Regional Services wrote to the Chairman of AsA that he was ‘...disposed to accept the Board’s advice that the level of risk does not warrant at this time the cost of introducing approach radar control services at the 10 regional locations. However, without more work and analysis about alternative approaches I am not yet fully comfortable with modifying the Direction.’ It is clear from these comments that AsA has concerns about the necessity of this project.

On 1 July 2007, the administration and regulation of Australian airspace was transferred from AsA to the newly formed Office of Airspace Regulation (OAR) within the Civil Aviation Safety Authority (CASA). In May 2009, the Minister wrote to CASA requesting advice on Ministerial Directive 2004-4. In August 2009, CASA wrote to the Minister stating that the Ministerial Directive 2004-4 was an efficiency tool but which had secondary safety benefits. In December 2009, the Minister wrote to CASA requesting additional information regarding the 10 regional

aerodromes. In February 2010, CASA wrote to the Minister stating that additional work relating to the 10 regional aerodromes was progressing, and a consolidated report was produced mid-2010.

The Qantas Group is of the view that the CASA advice to the minister failed to establish any safety basis to support the advice and also failed to specify the classification of airspace. The Group does not believe that there is a compelling case on the basis of improvements to the efficiency or safety of airspace management at the proposed 10 regional locations to warrant the significant expenditure associated with this project. On this basis the Group believes this project should be removed from the LTPA.

Allocation of costs

The LTPA provides an incentive for AsA to pull costs forward to ensure that it can demonstrate the annual spend required to retain a portion of these funds for the following year. This process should only be allowed to occur with the approval of the airlines and when it is in the best interest of the industry to do so. For example, to take advantage of favourable exchange rates as a number of the key technology initiatives are purchased from overseas suppliers which may at times make this an attractive option.

The Qantas Group considers that the Pricing Consultation Committee (PCC) should be the forum in which to openly review and support such activities.

Brisbane/ Perth Cat 9/10 ARFFS

The Qantas Group does not currently have plans or intentions to operate Category 10 aircraft to Perth and Brisbane airports in the next 5 years. In the absence of Qantas or another airline actually indicating an intention to operate Category 10 aircraft to these ports, it is unnecessary and premature to provide for and charge for these additional services. The inclusion of these costs prior to operations being confirmed will effectively be pre-funding and is an unnecessary cost to impose.

The Qantas Group believes that the costs for category 10 ARFFS should be isolated from the Cat 9/10 charges.

The group proposes than an ACCC approved model for the pricing of uncertain or new capital expenditure should be used to adjust prices outside the LTPA such as is used by Sydney Airport for the pricing of Necessary New Investment (NNI).

Capital expenditure- accountability

There is currently little or no accountability in the LTPA to ensure that capital is expended in an efficient and desirable manner. Considering that the LTPA contains a proposed capital spend of almost \$1 billion, it is critical that there are mechanisms to ensure the funds are well spent.



The Qantas Group believes that the appropriate way to manage this issue would be to manage and monitor expenditure collaboratively at PCC meetings. To this end, the Group seeks clarification that the PCC is intended to be the forum in which to consider and evaluate capital projects and their financial milestones, including operational expenditure. Further clarification is also requested around what AsA describes as 'major projects' in the Services Charter. In line with the intent of the Services Charter, the Group anticipates that the classification of items specified as 'major projects' would be agreed in conjunction with the PCC.

In support of AsA's desire to improve service delivery and performance outcomes, the following proposal is put forward as the Qantas Group's minimum expectations of the AsA during the LTPA time frame:

- Each project would be supported by a business case that demonstrates the benefits that the project would offer to the industry;
- AsA and industry would agree on the key delivery, financial milestones and time lines of deliverables prior to the commencement of the project;
- The key delivery and financial milestones should be tracked and reported to the industry prior to each PCC; and
- The PCC should have the projected capex and opex spend for each reporting period and thus be in a position to resolve any discrepancies and negotiate any new items.

Whilst this model of governance is more detailed than what is specified in the Service Charter, it needs to be acknowledged that the assessment of delivery milestones should occur prior to the PCC meetings. This is best achieved by a wider body of technical experts providing an assessment and report to the PCC. Each PCC member will then be better prepared to review the financial milestones to facilitate better outcomes at meetings.

Prefunding of capital expenditure

The LTPA currently contains elements of prefunding including a project costing \$200 million. In addition to direct prefunding, there are a number of rolling programs which are likely to also contain a significant portion of prefunding. Prefunding can also occur when a project is delayed or where assets are purchased in advance of project requirements. All forms of prefunding are unreasonable and unacceptable to pass through to airlines in the LTPA. Until a project is completed and the airlines and passengers obtain a benefit from the project then there is no justification for these charges to be passed through.

Another significant issue with prefunding in the LTPA is that a high WACC containing a return on equity and debt is currently applied and recovered prior to completion of the project. In some

cases, it may be justified to capitalise debt funding costs into to the asset value once the project is complete and costs can be passed onto the users.

The Qantas Group believes that the current direct prefunding in the LTPA should be removed, the capital plans should be scrutinised for achievability and a process put in place for capital expenditure accountability.

Risk sharing arrangements

The Qantas Group believes that the risk sharing arrangements proposed in the LTPA are somewhat one sided and do not effectively share the risk for activity and capital expenditure. They may also drive undesirable conservative cost and activity forecasts. Currently there is only one general mechanism with triggers for traffic under/over recovery and underspend of capex budget to share the risk. This comes in the form of a rebate paid to airlines six months after the financial year has ended.

This current structure provides little incentive for AsA to tightly control capital expenditure as the underspend has to be considerable before the trigger point for a rebate is reached. The current structure and \$980m capital plan means airlines and passengers could potentially prefund significant sums each year. The current risk sharing arrangement also provides little disincentive for warehousing in order to reach capital spend targets. In simple terms, this means AsA may have an incentive to spend on infrastructure assets (rather than provide a refund to airlines) that effectively sit in a warehouse unused until a project is ready to progress. This is another form of prefunding for which customers receive little or no benefit.

Rather than the current rebate structure, it would be preferable for passengers and airlines to have a lower unit cost from the outset of the agreement. The Group also considers that there is merit in examining risk-sharing arrangements between AsA and the airlines at individual locations. In particular, it may allow for price reductions or rebates to the individual airlines contributing to strong growth at a particular location.

Conclusion

The Qantas Group believes there are significant reasons to review the charges using:

- An economically sound methodology for the calculation of TN charges (as proposed in June 2010) to achieve AsA's pricing objectives;
- TN basin pricing to include Gold Coast and Sunshine Coast in Brisbane and Avalon in Melbourne;
- Continued cross subsidisation by Enroute and allocation of TN costs that are used by Enroute operations;
- Activity Forecasts based on longer term trends and ASKs;

- Non circular Building Block models for all charges;
- WACC commensurate to a AAA+ rating; and
- Excludes from the LTPA capex for unconfirmed or prefunded projects or services.

Also to:

- Review the risk sharing mechanisms;
- Use an ACCC approved mechanism to price isolated projects or services; and
- Further develop the Services Charter to incorporate capex and opex review and accountability mechanism.

At this stage, the Group cannot determine the reasonableness of the charges and it objects to the significant increases in charges for FY12 and FY13. Further detail and collaboration is needed to ensure the most appropriate technology and infrastructure are utilised. The Group looks forward to further dialogue and a response from AsA on the items contained within the Conclusion above in order to best synthesize the contents of the submission into a pricing proposal as appropriate.

Appendix 2: Capital Expenditure Concerns

Item	Project	Comments
various	Medium and minors	This totals \$97m over five years and represents 10% of the total Capex budget – more visibility required
2	Fire Stations (New and Replacement)	Provide a breakdown for each year. Need to understand how each figure was reached, in particular the \$8.5m that is repeated for 2014-16.
3	Canberra Fire Station Extension and Workshop	Has any compensation been received by Airservices from CIA due to the relinquishment of its lease when it relocated to new area?
8	Fire Vehicle Replacement Project – Stage 4	More details required
16	Mercury project	We need to get some industry structure around this otherwise we will all be duplicating information.
17	NAIPS.	NAIPS is primarily a general aviation tool and generally not accessed by the Group and is a candidate for the “user pays” approach. Very hard to see what is included in this, such as where is the new message integration hub? We need a lot more detail to assess this. We also need to have some major input into this as does Virgin. This must be an industry solution
19	Remote provision of Tower Services	This is labelled “implementation” implying not just R&D or a trial. Can AsA provide clarity around this project’s state including; proposed sites and the forecast net savings (from the business case)
20	CDM tools and development	Does this capture all 3 proposed CDM implementation phases? And will it deliver the ICAO SWIM concept? There is a need to work closer to define the end to end business solutions, and seeing what benefits we can get out of the product
21	NOC	\$11m – what is proposed in the way of “flight briefing”? Clarity is sought on benefits to airlines
24	NTP	At this considerable cost the new Tower technology must anticipate and be fully compatible and support the future replacement for TAAATS (2015+). How can this be done if the new system is not yet operationally specified?
35	NTP New Towers	Rockhampton, Melbourne and Adelaide new TWRs are programmed for implementation by March 2012. While there is reference to ‘one other new’ there are two further allocations of \$16m in 2014 and \$20m in 2016 – clarification requested
39	Canberra Office Fitout	Canberra AWB has undergone a major refit in recent years and the facilities and meeting rooms seem to be of a higher standard than enjoyed by the rest of the aviation industry. What is the justification for a Café when there are many nearby? If deemed necessary could it not be a commercial (leased) undertaking at neutral cost to AsA, and, thereby, not included in capital works program relating to aviation. Additionally a new child care centre exists across the road from the access walkway to the north. Have alternative business models been considered for what are essentially commercial endeavours
41	Melbourne (Site & Centre Redevelopment)	The new Melbourne tower is provided for in item 35 and the TAAATS Centre is currently ‘state of the art’. What will this extra deliver? Justification is needed for why a new building must be constructed
44	Business Systems Server and Application Rationalisation (Data Centres)	We question whether the replacement of Data Centres is money well spent. Are there data centre services in Australia that could support high availability applications?

45	Financial Systems Upgrade (SAP)	Please advise why AsA are running SAP hosted inside? ERP suppliers have been moving steadily to 'ERP as a service'. Qantas' Loyalty system and Amadeus are two good examples of this. The costs around local hosting and support are very high
67	Surveillance & approach facilities at regional airports	Surveillance (radar/multlat) exists down to varying levels at all but 4 sites. The "radar" direction and subsequent advice from CASA/OAR did not necessarily envisage a full TCU style approach / departures service (as has been the interpretation by AsA) but rather surveillance based service which could be provided from the overlying sector within CTA steps (confirmed by the author of the CASA response to the Minister at the last ACF with AsA executives in attendance). The tower would retain some airspace for the purpose of managing the circuit (as in the current Class C "tower airspace" concept). This model is consistent with that in the US and endorsed by the Department in the Australian NAS. New surveillance and operational technology (eg ADS-B and remote towers) and alternative operational concepts (FAA architecture) provide a number of cost effective options and alternatives to a TCU in delivering this service which do not seem to have been properly considered. QF believes that the Capex proposal is an over engineering of the problem. It is generally accepted that positive separation services are no more workload intensive than Class G DTI and flight following services, so the net workload change to the overlying sector should be neutral. The costs associated with what is proposed are unacceptable given the lack of clarity around what is being resolved by the implementation
71	ITUP	What has been spent on these upgrades historically? How was \$6m pa reached? What impact will this capital have on maintenance costs?
75	CAT III ILS GNSS	Previous advice from AsA is that the ILS facilities are currently (or shortly will be) all technically CAT III capable. What is the foreseen cost (\$15M) to Airservices as ground infrastructure?
92,93,94	TAAATS hardware/ workstation/ VSCS	Exec
		These items support the existing Eurocat 2000 implementation and total \$76m up to 2016. The future ATM (Eurocat 2000 replacement) is proposed to be deployed from 2015. Is this interim expense justifiable?
96	ATM Future system	The 2015 and 2016 estimate is for \$191m. What is the total indicative cost and target delivery date of full replacement?