Virgin Blue Group of Airlines
PO Box 1034
Spring Hill QLD
Australia
Tel: +61 7 3295 3000
Email: virginblue.com.au
ABN 36 090 670 965

7 February 2011

Mr. Paul Logan
Manager Financial Strategy and Business Performance
Airservices Australia
25 Constitution Avenue
Canberra ACT 2601

Dear Paul,

Re: Airservices Australia Draft Price Proposal December 2010

Virgin Blue Airlines (VBA) welcomes this opportunity to submit its comments to Airservices Australia (AsA) regarding its Draft Price Proposal December 2010. VBA also appreciates AsA's willingness to extend the response for feedback to 7 February 2011.

Since April 2009 the aviation industry has seen a drastic increase in planned CAPEX activity by AsA from $750 million to close to $1 billion today. This represents a $250 million or 33% increase in the past 18 months. Although a rough analysis of the costs has been provided by AsA at various meetings throughout 2010 it appears that items are too readily included and then removed once scrutinised. VBA is still of the opinion that greater transparency and further industry input including visibility of business cases pre sign-off and earlier in the decision-making process needs to take place.
Additionally, performance cost reporting on CAPEX and OPEX each year would be beneficial to see that value for money is gained for airlines and also assist in an explanation of the risk sharing activity. VBA does not support any CAPEX pre funding being included prior to receiving the benefits.

A key question to be asked in relation to this proposal is the extent to which industry can continue to support increases of this magnitude, or perhaps more importantly, whether it can justify the inevitable impacts of increases to fares on consumer demand and downstream industries.

On page 5 of the Draft Proposal AsA states that '**over the next five years proposed prices will provide real price reductions of more than six per cent against general inflationary pressures of costs rising at about three to four per cent per annum.'**[1]

[1] Draft Price Proposal, p. 5.

VBA would expect that any general inflation indexes used by AsA to escalate future operating and capital costs are consistent with official Australian inflation forecasts.

VBA has previously suggested that AsA should be required to prioritise its projects as this would serve as a good "risk management" strategy, i.e. in the event that unforeseen events were to occur at some future point in time, the program could be quickly contracted to account for any adverse impact on revenue. In light of the magnitude of the proposed increase, we would reiterate this point.

Furthermore VBA is now seeking to establish an industry agreement on the acceptable level of increase for future five year plans. Clearly there is a limit to industry's capacity to fund an expenditure program which significantly increases from one five year period to another. VBA is of the opinion that the same disciplines need to be applied to assessment of these plans as expenditure on any other major cost item associated with our business activities.

Whilst airlines recognise that capital investment is necessary, AsA must similarly recognise that the industry has an obligation to ensure that the shareholders receive the benefits of operating both efficiently and profitably. The fact that the industry may have a theoretical capacity to fund a large capital investment program based on strong predicted passenger growth does not automatically translate to a willingness on the part of the industry to endorse such a program especially where the impact on shareholders and passengers is expected to be detrimental.

The impact of interest rate increases during the life of the CAPEX must also be taken seriously. An increase from five percent to six percent represents a 20 percent rise in the cost of the borrowings.

One suggestion is for AsA and industry to agree on an upper limit to the increased expenditure between CAPEX agreements and to ensure that the CAPEX remains within that limit. The importance of this limit cannot be overemphasised, as it will force a strict control on proposed future increases. Based on current assumptions VBA would envisage total yearly CAPEX costs to reduce to $100 -120 million by 2016-17.

As previously mentioned, current CAPEX forecasting by AsA over the next five years indicates a substantial rate of asset replacement. VBA recognises the importance of this program but would stress that the replacement of any system be first evaluated against best whole of life cost and the basis of what increased efficiency the system can deliver. VBA strongly opposes any CAPEX that has been allocated to maintenance or upgrade of obsolete or outdated systems or equipment.

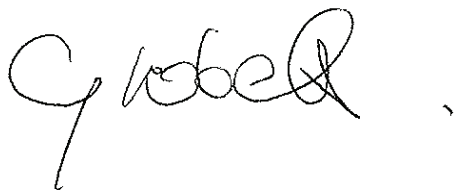
On page 124 of the Government's National Aviation Policy White Paper it is noted that ' **These technologies and innovations can offer better safety and efficiency outcomes often at much lower cost than the requirement for investment in new or replacement infrastructure'.**

Specific comments pertinent to each service under the draft pricing proposal are set out in the attached. These comments are framed in the context of the following questions, which reflect the importance of efficiency in the provision of these services to enable VBA to deliver sustainable, competitive fares to the travelling public in a safe manner:

- has AsA explored every single opportunity possible to reduce costs?
- are services being maintained at locations where demand has reduced to the extent that all of the services may not currently be required, and if so why?
- are all of the necessary criteria for the establishment of new services being fully observed? and
- are all resources best allocated to locations that warrant the services?

VBA acknowledges that AsA has a statutory obligation to ensure safety and that in order to remain a world class air navigation service provider significant investment is necessary. However, we would strongly encourage AsA to recognise that the industry is subject to an increasing variety of other cost burdens which continue to place upward pressure on airfares, and that in this context, every effort should be made to limit the size of the capital expenditure program.

Yours sincerely



Guy Roberts
Manager, Operations Procurement
Virgin Blue Airlines

ATTACHMENT

Enroute

VBA acknowledges that AsA is not proposing any increase to the enroute pricing.

Industry has requested that prices to be based on different Service Delivery Environments (SDE). Although initially open to this offer, AsA has elected to defer this costing model until the next long term pricing agreement (LTPA). If SDE's are implemented during the life of this agreement, clarification is required concerning the cost impact to industry and how this would be managed from a pricing point of view.

VBA has been the main advocate for the removal/ decommissioning of those navigational aids which are not included in the backup network. Although there removal has now been agreed, savings are yet to be realised. VBA is somewhat concerned that these savings have been transferred to cross subsidise other expenditure.

As part of the LTPA VBA has heavily invested in new technology, but we are yet to see the full benefit anticipated to be derived as a consequence of combining the use of the new technology with a more efficient ATM airspace platform. ADS-B is one such example the expectation being that AsA would deliver a more efficient Upper Airspace management model (SDE) to support the benefits of ADS-B. A significant component of the efficiency that was expected to be derived from the new model was a reduction in the number of Air Traffic Controllers required to deliver the service.

VBA's expectation moving forward is that AsA will achieve its targets for both technological and ATM efficiencies as contained in the business cases supporting the CAPEX program within the life of the CAPEX.

Terminal Navigation

AsA is proposing an increase to terminal navigational pricing.

VBA is strongly opposed to the use of average airline industry MTOWs as the preferred method of charging and would want to reserve the right to review this during the life of the five year agreement should our internal fleet model change. Average MTOWs are based on all aircraft operations and not operator specific. The average weight charging removes the ability of Virgin Blue to manage its fleet capabilities through differing MTOWs and removes any competitive advantage that may be achieved through more efficient fleet planning. Should average weights be desired by AsA they should only be implemented as a company average weight and not an industry average weight.

AsA's decision to adopt the principles arising from the 2010 terminal navigational pricing review is regarded by VBA as a move in the right direction. The move to location specific costs being recovered by that location is a welcome key efficiency driver, including further work towards a full cost recovery model over the coming years.

VBA supports a 12 month review of activity forecasts for new service locations as proposed by AsA.

There is a number of other aspects of immediate concern, none more pressing than the CASA directive surrounding the surveillance approach radar.

VBA is particularly concerned at the lack of consultation with regard to the options that may be available to deliver the intent of the Ministerial Direction. VBA has consistently expressed the view that AsA's decision to provide an approach control service at all Towered Regional Aerodromes should be based on an ICAO performance case assessment and be further supported by a risk analysis.

Although VBA intends to comply with the surveillance approach radar direction in its current form, we would question the criteria for its establishment and the possible ramifications for industry in pushing up airline costs and in turn costs for the travelling public.

VBA would welcome the opportunity for further discussions on options that may be available to satisfy the intent of the Ministerial Direction ahead of AsA committing to an implementation program.

Another area of concern to VBA is AsA's intention to absorb the cost of the Class D GAAP towers into the major airport terminal charge. Given the magnitude of this increase (4.5%) as a consequence of this regulatory change, VBA is of the view that the charge should be attributed to those operators that use Class D aerodromes. VBA challenges ASA's assertion that the new Class D service delivers more efficiency to the airspace users of the adjacent major airport.

VBA is also concerned that AsA does not appear to be proactively scrutinising the need for services at some regional locations as part of the CAPEX review. Activity levels at both Coffs Harbour and Albury do not support the need for a control tower service. VBA is strongly of the view that the limited resources should be deployed to those locations where the ICAO performance case and risk analysis supports the need.

In the case of Tamworth, the RPT activity level is lower than the threshold required for a tower service, but the overall movement rate is high. The question that needs to be addressed is why non-users of the service should be required to fund it.

VBA notes that Sydney has 100 Air Traffic Controllers which is more than both Melbourne and Brisbane even though these centres provide coverage for enroute sectors plus their relevant airport. In contrast, Sydney is only required to service Sydney airport and terminal airspace.

There is no apparent roster coverage pattern for both ATCs and Aviation Rescue and Fire Fighting Services (ARFF) tied to activity levels or times of operations in all cases. VBA would like to see AsA provide a clearer explanation of how the resource requirements have been derived on a site by site basis.

For example is that Cairns has 32 Air Traffic Controllers for 70,042 movements per annum while Coolangatta has 22 Air Traffic Controllers for 91,462 movements per annum. It is unclear whether this difference is indicative of the fact that Cairns ATC is responsible for providing approach/departures in addition to tower services or attributable to some other factor.

ARFF

AsA is proposing that category based charging methodology will continue although the cost of providing the services will increase, and the combined category 9/10 price will also increase.

Review of the services information for pricing reveals that there is a quite significant gap between ARFF Category 6 and Category 10 resources, as well as some inconsistencies in the number of ATC resources at different locations. Again, there appears to be no apparent roster coverage pattern for ARFFs tied to activity levels or times of operations in all cases.

In scrutinising the allocation of funds for individual fire stations it must be noted that a substantial amount of money has been allocated to fire stations where aircraft movements and the demand for services are seeing a trend downwards.

VBA would further like to seek clarification and the underlying rationale why AsA deems this as a necessary expense.

Ayers Rock is a prime example where the activity levels do not justify the requirement for an ARFF service and VBA would seek to have those resources re-deployed to a location where the need has been identified. The significant costs associated with a fly in/fly out operation are also of concern.

We would also seek information on whether a Category 10 airport only has Category 10 tenders or whether the ARFF unit has an independent Category 6 capability supplemented with a Category 10 capability.

Further clarification is also required concerning the level of the costs of upgrading the Learning Academy Hot Fire Training Ground attributable to the competencies required to deal with large, complex airframes such as B747s and new A380s, in particular whether these costs will be allocated to the users of the Category 9/10 service.

Infrastructure Towers Replacement

Once again, VBA seeks further clarification from AsA in relation to this proposed program in particular, whether all of the 32 Non Directional Beacon (NDB) sites require the towers to be replaced part of the backup navaid network and whether AsA has fully investigated the option of deferring the work on NDB towers until post 2016, thus providing an opportunity to retire the NDB.

TAAATS Upgrade

Virgin Blue notes AsA's comments contained in the Minutes of the Pricing Consultative Meeting held on 26 October 2010; **'Whilst there is some uncertainty around the details of TAAATS expenditure there will be a comprehensive business case that industry will be consulted on before a commitment is made. It is important that we understand industry's appetite for the new system and their respective support'**

The CAPEX allocated to the TAAATS upgrade or enhancing the current system to meet user requirements during this five year pricing agreement runs close to $200million, although the delivery and rollout of the system will only fall into the next pricing agreement. VBA is strongly opposed to funding services ahead of their implementation. VBA would assert that this would be similar to getting our guests to pay for our aircraft orders before they've had the benefit of using the services.

Against this background, VBA is not willing to endorse such a significant amount of expenditure prior to having an opportunity to review the business case.

Building and Property

The allocation of $10 m of industry funding to upgrade the Canberra Office complex, including the establishment of a childcare facility is noteworthy. VBA does not believe that industry subsidisation of such property works is appropriate.

CAPEX -Risk Sharing

VBA would like to raise a concern regarding the shortfall in capital expenditure which triggers the risk sharing activity to occur. Whilst this method is unchanged from the current LTPA, given the substantial level of requested capital expenditure, VBA considers that the 50% of agreed expenditure in a single year or 25% on a cumulative basis is too low. There is insufficient incentive for AsA to progress with all the capital investment and as a result airlines are pre-funding projects by their inclusion in the calculation of the proposed pricing. It would therefore be beneficial to have sight of major business cases before sign-off and also to receive financial statements on the level and nature of the CAPEX each year. Further to this we would request that the trigger level for the risk sharing activity be raised to a higher level, desirably to 75% of annual CAPEX. This will ensure projects are delivered and benefit is gained by airlines and their passengers.

CAPEX - Delivery

VBA has a concern over AsA's capability to deliver the intended CAPEX program during the five year pricing agreement. Past experience suggests AsA has not performed well in this area.

VBA has further concerns on how it can limit its exposure to this and bracket our investment. For example a 10 percent overrun on the TAAATS initiative would equate to approximately $20million, which AsA may seek to recover from another area of the CAPEX. VBA would suggest that AsA wears all risk regarding a budget overrun. VBA would welcome the opportunity for further discussions with AsA on a mechanism that provides greater risk mitigation.

WACC - Debt Margin

In the calculation of the Weighted Average Cost of Capital (WACC), the level of debt margin has increased 1.75% since the last agreed LTPA. Whilst VBA recognises that the cost of debt has risen in the short term from the effect of the Global Financial Crisis, we would like assurances that a longer term view of debt financing (possibly a seven to 10 year projection) is being used given that to this agreement is being set for the next five years.

As the Standard Costing method has been used to calculate location specific costs, VBA would like to understand whether there are any differences in the costing used for major ports and regional ports. As this is a "user pays" model, the use of Standard Costing may distort the proposed cost recovery of both major and regional ports. Additionally, standard costing has also been used for depreciation costs. However, there is no indication of the useful lives of assets being used to calculate the depreciation. Given the requested level of capital expenditure, VBA would like to see examples of the useful lives applied to asset categories to ensure accelerated depreciation is not being included in the LTPA.

General

VBA seeks transparency of all business cases for initiatives over $10 million. For each of the approved expenditure initiatives VBA seeks a commitment to be regularly updated as to how the project is tracking in line with the objectives as detailed in the original business case.

VBA are keen to see how the harmonisation process in relation to the provision of air navigational services between AsA and the Department of Defence is progressing. VBA would have the expectation that leading into the next round of pricing discussions in 2016/17 that the consolidation of combined procurement efforts will lead to greater efficiency gains thus generating a further reduction in CAPEX and OPEX costs.