SUBMISSION

TO

Airservices Australia

Review

ON

AIRSERVICES AUSTRALIA'S
Long Term Pricing Agreement Discussion Paper

5 May 2015

Table of Contents

Page

Executive summary

The Qantas Group appreciates the opportunity to make a submission to Airservices Australia's (Airservices) Long term Pricing Agreement (LTPA) July 2016 to June 2021 Discussion Paper.

The Qantas Group operates regional, domestic and international passenger and freight services, employing 30,000 people with approximately 93 percent of these based in Australia. The Qantas Group is Airservices' single largest, and most diverse, customer. Airservices' charges represent the Qantas Group's largest external expenses to a service provider behind the purchase of fuel.

The current Airservices pricing regime has been in place for the past 11 years. The Qantas Group generally supports the current methodology whilst encouraging an increased focus on productivity, sustainability and efficiency without compromising safety. We acknowledge that Airservices' information sharing and transparency have improved and we are encouraged by Airservices' willingness to work with industry.

The expectation of the Qantas Group is that the pricing review will deliver:

- Productive, cost efficient and sustainable services for the industry;
- A transparent review of substantial dividends, retained profits and taxes to ensure they are fully used for the delivery of aviation services;
- Accountability and delivery of cost effective services; and
- Operational improvements.

Our project priorities in order for the next funding period are:

- Airport Collaborative Decision Making (A-CDM) including Departure Manager (D-MAN);
- Required Navigation Procedures (RNP);
- Technology to enable Flexible Tracks and User Preferred Routing (UPR);
- Metron Traffic Flow (MTF) Harmony upgrades;
- Other Collaborative Decision Making (CDM) including Meteorological CDM;
- Airport Capacity Enhancement (ACE); and
- Support for other technologies such as Ground Based Augmentation System (GBAS);

It is expected that these projects are delivered as soon as practicable within the pricing agreement in order to achieve the safety and efficiency goals. It is recognised that Airservices have committed to delivery of a new Air Traffic Control system within the next pricing agreement. Qantas supports this project whilst emphasising that operational efficiency must continue to be delivered.

Our concerns on the current delivery are:

- Airservices actual capital expenditure has been focused on building projects and replacement of assets; rather than the delivery of new technology;
- Expenditure has been higher than set down in the LTPA; and
- Under-delivery of planned projects related to technology and productivity improvements.

Consequently, the industry is bearing a regulatory burden without the benefit of productivity gains.

The structure and efficient delivery of the funding model can have important implications for the viability of airline services. This should remain an important consideration in any moves towards implementing location specific pricing at already commercially sensitive destinations, particularly in regional and rural Australia. The pace of change should be determined by pragmatic rather than ideological considerations to ensure service delivery is not compromised.

Qantas has concerns about risks associated with the prefunding or accelerated funding of services that may become stranded. It is essential that Airservices continues to consult fully with industry on all aspects of its proposed capital expenditure program.

Response to Questions

Question 1: Pricing Principles

Do Airservices pricing principles sufficiently capture the interests of industry in targeting equitable and efficient pricing outcome?

In the absence of pricing details to assess the merits of any alternative options, the Qantas Group considers the current methodology for the pricing of Terminal Navigation (TN), for Aerodrome Rescue and Fire Fighting (ARFF) and Enroute services to largely be balanced and equitable.

Airservices' prices on average have been increasing between 3-4% per annum. While Airservices' general activity growth has been broadly consistent with that anticipated under the LTPA, it is important to note operating costs are higher than anticipated. As with all other sectors of the aviation industry it is important that these costs are actively managed by Airservices and efficiency dividends continue to be delivered. Equally, the delivery of capital projects has been materially delayed and forecast expenditure will likely exceed that in the LTPA. Failure to deliver projects on time and at projected cost has significant implications as these projects are inevitably moved into the next pricing period, exposing industry to material price increases.

Based on its annual reports, Airservices has consistently made a profit before tax in each of the past four years, provided dividend payments to the government and payed corporate tax. Airservices is fully funded by the aviation industry. It is therefore important that surplus funds are directed fully and transparently towards the provision of services in support of the aviation industry.

Question 2: Rate of price increase

At what rate should prices increase to remove inherent cross subsidies between services and locations?

The Qantas Group understands and supports the principle of economically efficient pricing models. The application of these principles should not however be driven solely by ideological considerations but rather reflect the complexity and challenges associated with the delivery of essential services to regional and remote communities. These are complex issues and care must be taken to ensure that transitional policies, including pricing mechanisms, are implemented in a manner which maximises all aspects of the national interest.

It is well understood the pricing effects for the delivery of services at locations with low levels of activity are higher than for ports with high levels of activity. As an illustration of the complexity of managing transitional change, there is a risk that full cost recovery in some circumstances may be the difference between airline services being provided or not. New ARFF or TN services provided at a particular location will increase costs and in turn affect the viability of services to some locations. Removing the smoothing effects of hybrid pricing could bring cost pressures to regional routes including locations such as Newman, Port Hedland and Coffs Harbour where significant costs for these services have recently been incurred. Care must be taken to ensure that unintended consequences are avoided in the development of revised cost recovery mechanisms.

Managing the recovery of the cost of providing services to the aviation industry should reflect a holistic approach to all aspects of the service model and not solely focus on cost recovery. It is equally important that Airservices continues to achieve operational savings, including the reduction of red tape and continues to work with CASA to ensure appropriate cost efficient standards are applied to improve the industry's long term efficiency and competitiveness.

The current regulatory model encourages capital investments which generate a WACC return for Airservices. Care must be taken that this does not come at the expense of technological innovation and service improvements which benefits industry such as measures to reduce aircraft fuel use, emissions, delays and diversions. The downstream benefit of this approach includes improving the efficiency and longevity of airport infrastructure which is increasingly coming under pressure. Surplus funds need to be prudently invested back into services for the benefit and sustainability of the aviation industry.

Question 3: Measuring Performance Outcomes

Does Airservices Services Charter adequately cover the key service performance outcomes that are of the highest priority to the industry?

The Airservices Charter provides an important opportunity to measure performance outcomes and to ensure ongoing accountability. In the next pricing period it will be important to continue to concentrate on service outcomes, results and benefits, including a commitment to provide, where appropriate, an improved level of service beyond the minimum needed to meet regulatory requirements.

Industry must be closely engaged in discussions concerning prioritisation of projects and ensuring the allocation of scarce resources reflects industry priorities. A number of industry priority projects have either not been delivered or delayed in the current pricing period. Projects such as the Required Navigation Procedures (RNP), Airport Collaborative Decision Making (CDM) including Departure Manager (D-MAN), Harmony-Metron upgrades, Ground Based Augmentation System (GBAS), Airport Capacity Enhancement (ACE) and Automatic Dependant Surveillance – Broadcast (ADSB) projects are all centred on industry efficiency and improved performance. All of these projects have experienced significant delays, less than optimal outcomes or cancelled. Qantas recognises that a number of delays have been beyond the control of Airservices and is willing to work closely with Airservices and other stakeholders to ensure these matters are addressed and industry benefits are optimised.

Ensuring an appropriate balance is achieved between projects which improve industry productivity and efficiency and those which fund alternative building, asset renewal and regulatory services needs close collaborative engagement between the industry and Airservices. Industry contribution to the prioritisation of projects, particularly the ICAO Aviation System Block Upgrades (ASBU) framework, will provide the greatest benefit in terms of safety and efficiency. In the present environment we are concerned that balance has not been achieved, resulting in increases in charges without necessarily improving productivity, efficiency or safety. With the OneSky project currently consuming additional operational and capital resources, delays are being experienced in the delivery of projects which will provide industry benefits in the short term.

Qantas Group noted in its 2011 pricing submission for the current LTPA that the $180m placeholder in the capital plan for the new Air Traffic Managements system now named the OneSky project effectively amounted to prefunding. Benefits of the OneSky project are unlikely to be delivered until well into the next pricing agreement and questions remain about the economic efficiency of prefunding by current users of infrastructure for the ultimate benefit of future users. Attention needs to be given to the current practice of generating a WACC on all capital projects during construction when the more appropriate measure would be to apply a debt rate commensurate with the costs to fund projects during construction. Qantas believes Airservices should only apply a WACC return after the project is commissioned.

There are elements of the current pricing model and, more broadly, the decision making process which we believe are unsustainable. Airservices' can improve the delivery of projects and services in order to encourage technological evolution and innovation and to actively demonstrate improved productivity and cost recovery. Once a project plan has been agreed with industry specific Key Performance indicators linked to pricing or rebates ideally need to be set.

Question 4: Graduated services

Is it appropriate to commence charging for services such as the Aeronautical Flight Information Service (AFIS) being provided at Port Hedland? As other graduated services are developed over the course of the next pricing period, how should Airservices introduce a price for these services?

The Qantas Group considers that charging for AFIS at Port Hedland is reasonable because it is an additional service being provided instead of a tower service. The TN pricing methodology may be an appropriate framework; however, as discussed earlier, the effect of price increases must be considered against the viability of airline services to commercially marginal ports. Price changes need to be implemented over a reasonable time frame.

The Qantas Group supports the review of emerging and current level D aerodromes for the potential implementation of AFIS. However, the step change to full tower services in regional locations imposes a material cost on routes to these locations. Cost recovery is an inherently difficult exercise for airlines. It cannot be assumed that all costs of services are, or can be, passed on to passengers, particularly in circumstances of a material step change in charges. Moreover, it has proven increasingly difficult, if not impossible for carriers to recover increased costs through sustainable fare increases on many regional routes without relying on airline network efficiencies. Given the push for Airservices to move towards location specific pricing the irony of this situation must not be overlooked. There is, inevitably, a limit to how far airlines can sustain such practices.

With respect to the other services such as TN services, the Qantas Group considers that further resources and funding should be committed to innovation and development of remote tower services. The Qantas Group understands that research and development into this technology has ceased, which is disappointing for Australian airlines and regional airports. Airservices and the Government should be supporting the continued development of this technology for the future benefit, safety and productivity of regional Australia.

Question 5: Premium or Value Add services

Should Airservices separately charge for more customised services?

The Qantas group encourages the implementation of innovative technologies for the long term safety, efficiency and sustainability of the industry and the environment. There should be encouragement for broader use of these technologies. Where the 'premium or value add' services are on the Air Navigation Service Provider technology roadmap or are considered a cost effective industry innovation, then cost recovery across the industry is a reasonable approach. It is important that technologies such as RNP are seen as technology development rather than a value added service.

Question 6: New technology incentives

Should Airservices use its charges to encourage the adoption of new technologies to improve overall air traffic management performance and/or enable the decommissioning of legacy systems? If so, what form could the incentives take?

The Qantas Group supports the adoption of incentives to encourage the majority use of new technology which provides improved industry productivity, efficiency and safety.

The mass adoption of new technology such as RNP, ADSB, and GBAS enables decommissioning of expensive legacy technology and facilitates key industry benefits such as safety, operational efficiencies, increased airspace and airfield capacity, together with reduced diversions, delays, noise, fuel and emissions. This can also have the flow on effect of delaying the need for expensive airport infrastructure.

A number of mechanisms could be considered to incentivise the adoption of new technologies:

- Rebates or reduced charges for current users of technology;
- Mandates for technology use in airspaces, airways and aerodromes during peak times;
- Priority landing for technology users; and
- Alternative airfield use for those not technologically capable.

Some of these mechanisms may be subject to equitable access provisions however, they shouldn`t be discounted as they have been implemented at busy overseas locations.

Incentives have the capability to increase demand for new technology which in turn can stimulate innovation, reduce retrofit costs and encourage mass adoption.

Question 7: Deemed weight

Should Airservices continue to reduce the number of weight categories by assigning deemed weights to series of aircraft rather than individual models of aircraft?

The Qantas Group supports economically efficient charging models. Care should be taken to ensure that the application of pricing principles considers the reasons for MTOW variations amongst aircraft models. Aircraft of a similar or same size may justifiably have materially different deemed weights due to the sectors they fly. Short domestic sectors compared with longer international sectors have a lower amount of fuel and cargo thus lower registered MTOW, despite being the same sized aircraft. There are industry efficiencies generated by up-gauging, especially at congested airports, and this proposal may penalise network and fleet optimisation.

Question 8: Weight Cap

Is the current weight cap of 500 tonnes appropriate or should it be changed?

The Qantas Group supports maintaining the current 500 tonne weight cap. This approach effectively recognises that the largest aircraft in the sky should not be disproportionately charged more for equivalent services. Further consultation and understanding of the implications is needed before any support to change can be made.

Question 9: Deemed Distances

How should distance be applied for international operations and would an international route/sector based fixed distance minimise complexity and competitive advantage that may exist for aircraft that fly, what is ostensibly the same route? How often should these distances be reviewed?

The Qantas Group is supportive of a review of the deemed distances for international operations for the purposes of equitable and efficient pricing. The Great Circle distance between the usual entry/ exit point and the airport is the most efficient distance for any route. The use of Great Circle distance would also remove the need for reviews and provide cost certainty for users.

Question 10: Ultralights, Gliders and Balloons

Should Airservices commence charging for sport aviation aircraft undertaking commercial operations?

The Qantas Group considers that a sustainable contribution by all users for services is an equitable outcome. Where sport aviation aircraft require services then it would be reasonable for Airservices to charge those users. Given the high pricing effect at low volume aerodromes care must be taken that unintended consequences such as competitive distortions or unsustainable operations are avoided.

Question 11: Alternative mechanisms

What alternatives to the current basis of charging, should Airservices consider including as part of its pricing framework?

The Qantas Group would like to be actively involved in a detailed review or exploration of any alternative price options such as by passenger, movement, time based pricing or location-specific pricing. Without a clear understanding of the careful, objective consideration of the implications of a change in the basis for charging, it is not currently possible to support alternative methods for charging.

Question 12: General Aviation

How can the process for charging General Aviation (GA) aircraft be improved? Should the $500 threshold be reviewed?

As previously stated it is reasonable for all users to contribute to the provision of services with consideration for the sustainability of charges. The industry agreement for the GAO was for it to be cost neutral, not for industry to fully fund it. The costs of the General Aviation Offer (GAO) were to be funded from the administrative savings generated. However, this has not been possible due to the low take up rates of the GAO. Airservices could revert to the previous methodology whereby each activity was charged at the listed rate or, alternatively, adopt an innovative approach to administrative activity, such as General Aviation, for example, prepaying for services. Other forms of transport have adopted innovative solutions including prepaid tickets, online payments, prepaid cards etc.

Question 13: Risk Sharing

Are current LTPA risk sharing arrangements still appropriate?

The Qantas Group considers that risk sharing arrangements are needed and remain appropriate. There is an opportunity to improve the current methodology in order to focus on priority outcomes such as operational efficiency, productivity and cost effectiveness.

With respect to the activity risk sharing, additional mechanisms specific to service or location can be devised to more equitably share risk.

There are limitations in the current capital risk sharing mechanism whereby adjustments are provided to the industry when Airservices spend is less than 20% per year (or 10% cumulatively) than the capital plan. This risk sharing mechanism perversely encourages over spend, primarily on capital intensive projects rather than incentivising project delivery on time and budget. Currently industry bears the risk that that expenditure for new services exceeds those needed to prudently meet regulatory and safety requirements.

Over the current LTPA there has been a material shift and delay in capital spent and projects delivered. Spend on capital intensive projects exceeded the plan while technology and performance based projects prioritised by industry have not been delivered. The industry has contributed depreciation and the WACC return on assets that are yet to exist and foregoes the productivity benefit. Given the delay in capital spend the remaining asset value forecasted by the end of the current LTPA will be substantially higher than planned. Due to the pricing model mechanics the industry will be asked to again pay for depreciation in the next pricing agreement. The risk of project delays and overspend is borne by the industry rather than shared.

The Qantas Group recognises the challenges in developing a capital plan well in advance and suggests that the expenditure risk sharing mechanism evolve to include all major projects, being either capital or operational in nature. Considerations should be given to a risk sharing model that appropriately relates charges with timely delivery of projects within budgets.

Question 14: Stranded Assets

What is the most appropriate mechanism for Airservices to recover regulated mandated investments that become stranded?
What are the efficiency and equity implications of the four presented charging options, having regard to users' sensitivity to price changes and the need to avoid unwanted market distortions as a consequence of assets becoming stranded?

What is your view on the appropriate timeframe for cost recovery under the four options presented in relation to stranded assets?
Are there any other alternate charging arrangements which would deliver a preferable pricing outcome when assets become stranded?

History has shown that despite down turns, the market tends to recover over time. The Qantas Group does not support accelerated depreciation or additional charges in these locations as implied by the options proposed. Consideration needs to be given to the sustainability of a methodology that inequitably recovers costs in the early life of an asset with a long useful life.

The Qantas Group is aware that Airservices considers TN and ARFF services at locations which have experienced a very high growth rate in recent years to be most at risk of being stranded. This is true of many resources markets, with activity rising to levels triggering a new service. The provision of a new ARFF or TN service in some regional locations has resulted in fixed expenditure costs being between \$10m-\$20m. These costs are considered high compared with new services in other locations. The Qantas Group encourages more flexible and dynamic options for the provision of services in such locations.

The reduction of the commodities prices in Australia is putting pressure on the resource and FIFO market. A full or early cost recovery model may be the difference in some locations of airline services being provided or not thus increasing the likelihood of stranded assets. This is especially the case in locations with high variability in loads. The Asset Beta in the WACC compensates Airservices for risk inherent across the business and thus it is assumed sufficient industry funds are available in the long term to sustain an asset across market fluctuations.

The efficiency and the benefits of this level of spend for these new services have not been recently recalibrated with the current level of risk at these airports. Whilst acknowledging that services are provided to satisfy CASA regulatory requirements, the Qantas Group would support a review of the level of requirements and the trigger levels for new services. Aviation and aircraft safety has progressed materially over the past 20 years, yet the triggers and the regulatory requirements have not changed.