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31 October 2008

Mr. Andrew Clark  
Chief Financial Officer  
Airservices Australia  
25 Constitution Avenue  
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Dear Andrew,

### **Re: Price structure options discussion paper**

Emirates appreciates the opportunity to comment on Airservices' 2008 discussion paper on pricing structures for its regulated services.

Emirates currently operates over 8000 flights per year in Australian airspace. In 2007 we paid Airservices approximately AUD 37 million for enroute, terminal navigation (TN) and aviation rescue and fire fighting (ARFF) services. Emirates operates flights to over 100 destinations worldwide from our Dubai hub. However, enroute payments to Airservices Australia are the second largest made by Emirates to any air traffic management provider across our global network.

As well as price, the capacity, quality and availability of services affects the efficiency of aircraft operations and hence overall costs. Both price and service standards therefore directly influences Emirates' commercial opportunities and ability to successfully compete in Australia.

The structure of our response is as follows: The first section outlines Emirates' preferred pricing structure for enroute, TN and ARFF services. To support these pricing positions, the second section discusses our view on Airservices' role and the lack of justification for network-based charges. Finally, comment is provided on the individual questions posed in the discussion paper.

## **1 Price structures for regulated services**

### Enroute services

#### (a) Indian Ocean Sector

Emirates supports Airservices' proposal to directly link costs and prices for enroute services. The cost of providing enroute services varies significantly across Australia's flight information region (FIR) given differences in the level of service provided and associated infrastructure requirements.

Emirates supports the proposal to differentiate charges for the Indian Ocean airspace. Airspace over the Indian Ocean is international airspace allocated by the International Civil Aviation Organisation (ICAO) to Australia. A separate charge for this sector is an important initiative by Airservices, recognising that the cost of providing enroute services is lower than the rest of Australia's FIR. The initiative fairly distributes costs and signals to other enroute providers the price at which Airservices can provide enroute services in international airspace with similar service levels.

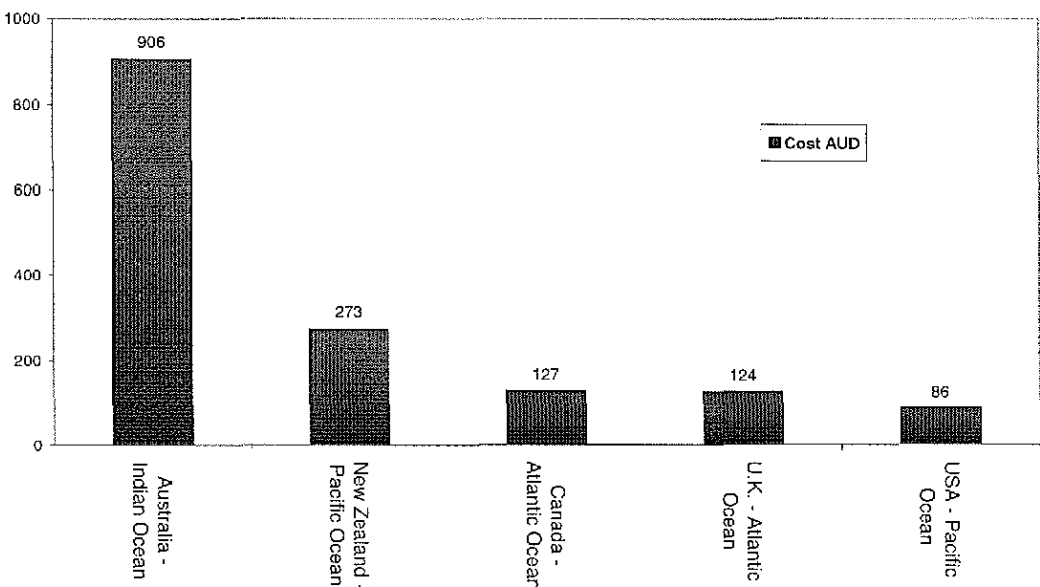
Technology now allows for a rationalisation in the number of worldwide enroute providers. There is a strong argument that enroute services can be provided more efficiently by fewer providers covering large areas of airspace. A charge that reflects the cost of providing an Oceanic service will encourage such developments by demonstrating which provider is more efficient. The initiative is therefore consistent with encouraging competition and a more dynamic industry in the long term.

Airservices' proposal means that the cost of enroute services across the Indian Ocean will be more cost competitive with similar airspace around the world. The United States, United Kingdom, Canada and New Zealand levy a separate Oceanic charge for enroute services.

As shown in the graph below<sup>1</sup>, the current Airservices enroute charge for an Airbus A380 operating 1000kms over the Indian Ocean sector is six times higher than the average fee levied for the same flight by other Air Navigation Service providers over major Oceanic sectors.

Canada and the UK levy a non-weight based flat Oceanic charge across the Atlantic Ocean. The US Federal Aviation Administration levies a distance based Oceanic charge for overflights only. As such, flights that land in the USA pay no direct Enroute charge.

Cost of flying 1000kms over Oceanic Airspace (A380)



The introduction of a separate Indian Ocean charge can be implemented without increasing the prices paid for enroute services by other customers. Current revenues from enroute services allow for targeted reductions in price and it is appropriate these reductions apply to the Indian Ocean sector where revenues and costs are misaligned. No customer is worse off under Airservices' proposal compared to the prices currently paid.

Over-recovering the efficient cost of providing an Enroute Oceanic service unnecessarily increases airline operating costs on International sectors and will have a direct impact on Australia's tourism and trade competitiveness.

(b) Maximum Take-off Weight (MTOW)

In terms of the charging formula, weight bears no relevance to the cost of providing enroute services to individual aircraft. Indeed, Emirates draws to Airservices' attention the recent decision to remove

<sup>1</sup> Based on IATA published rates using an A380-800 Aircraft with MTOW of 569 tonnes. Exchange rate applied is the average rate for the 2007/08 Financial year.

the use of aircraft weight in charges from ICAO pricing policies at the ICAO CEANS conference in September 2008. The ICAO Secretariat will produce a revised draft of ICAO Doc 9082 (charges policies), which will be submitted to the Air Transport Committee in October 2008 for approval and then to the Council in the November 2008

Emirates is disadvantaged by the current MTOW charging formula. In particular, our Airbus A340-500's are certified to an unusually high MTOW of 372 tonnes to accommodate the high fuel capacity required for our long mission lengths to Australia. The table below compares seat capacity and MTOW of our A340-500 and high capacity A330-200 aircraft.

**Emirates fleet – Seats Capacity vs Certified MTOW**

	<b>Airbus A340-500</b>	<b>Airbus A330-200</b>
<b>Seats</b>	258	278
<b>MTOW</b>	372 tonnes	230 tonnes
<b>MTOW per Seat</b>	1.44 tonnes	0.82 tonnes
<b>Australian Enroute Price per 100kms</b>	\$80.62	\$63.39

The A340-500 has a MTOW 62% higher than the A330-200 to accommodate additional fuel capacity. The current MTOW based charging structure unfairly generates an enroute charge that is almost 30% higher for the A340, while this aircraft has less production (seat) capacity and the same service provision cost as the A330.

Weight based pricing simply reduces the commercial opportunities of airlines that require greater fuel capacity to reach Australia. Enroute prices should be based only on distance. There is no economic justification for a weight-based component in enroute prices. For simplicity, distances can remain fixed rather than varying by the actual path flown by each aircraft.

**Terminal navigation**

TN services should continue to be priced on a location specific basis. Emirates is opposed to any further networking of costs as has occurred for ARFF services.

Future price caps for TN services should address three different scenarios:

- 1) towers close to, or achieving, cost recovery: prices can be set to recover costs each year or 'smoothed' over the pricing period based on the net present value of costs;
- 2) regional towers where a degree of under recovery still remains: prices should continue to transition towards full cost recovery by the end of the next pricing agreement; and
- 3) GA or other towers where cost recovery is unlikely: Airservices should agree with the Australian Government a level of cost recovery with funding of the shortfall through community service obligation (CSO) payments or lower returns.

In terms of the charging formula, there is again no relationship between aircraft weight and the services provided. Prices should be a fixed fee per landing and takeoff, recognising that the same service is provided to each aircraft regardless of its maximum take-off weight. MTOW charging penalises customers based on the fuel capacity of their aircraft.

If weight is retained, then the charging structure should comply with ICAO pricing policies. Emirates draws to Airservices' attention to the current ICAO pricing policy, which states that:

The Council recommends that where charges for approach and aerodrome control are levied, whether as part of the landing charge or separately, the charge should, so far as possible, be a

single element of the landing charge or a single charge per flight and could take aircraft weight into account but **less than in direct proportion**.<sup>2</sup>[emphasis added].

Currently, weight is taken into account in direct proportion. This is contrary to ICAO pricing policies. Should weight be retained, Emirates recommends that it be modified to the square root of the weight (to the power of 0.5) rather than the current direct proportion (to the power of 1.0).

#### Aviation rescue and fire fighting

Emirates remains opposed to the current network-based approach to setting prices for Aviation Rescue Fire Fighting (ARFF) services.

Airservices should unwind the current arrangements back to location specific prices over the course of the next pricing agreement. The total revenues obtained for ARFF services from each airport should be determined on a location specific basis.

In terms of the charging formula, weight should be removed and a flat fee per landing, per category of aircraft levied. The category 6 charge should represent the minimum level of service, which is paid by all aircraft at a location. The incremental costs for each higher category should then be determined, with the price based on the aircraft that require that level of service (and higher levels of service). It would be expected that the incremental cost of higher categories is usually modest compared to the category 6 costs.

## **2 Justification for the proposed price structures**

#### Airservices' role in the aviation industry

Airservices is a critical input provider that allows for the safe and efficient provision of civil aviation in the Australian FIR. Airservices' primary consideration should be on delivering the necessary capacity and quality of services required by the airlines underpinned by Airservices' continual focus on safety. This requires effective consultation with the airlines over the services to be provided and the investments necessary to deliver agreed services.

As a legislated monopoly provider, price setting by Airservices should be about recovering efficient costs. Prices should be set consistent with ICAO pricing principles and the requirements of Australia's National Competition Policy (NCP).

In its discussion paper, however, Airservices states that it might determine prices based on its perception over the financial impact it will have on individual customers. It will do this by underpricing services at some locations and hence promote the development of select routes. In its discussion paper Airservices states that:

...the price of terminal navigation services at regional and GA locations is at a point where demand impacts affordability are acute issues. This will be an important consideration, and feedback will be important to determine how existing prices impact various businesses and how a change in pricing structure would benefit or harm their ongoing operations.<sup>3</sup>

It is not appropriate for Airservices to subjectively seek to promote the development of certain routes and profitability of individual customers through the use of its market power. The pattern of aviation development should primarily be determined by the airlines, which in turn can be influenced by the privatised airports and other private input providers.

Airservices' governance arrangements are suited towards promoting the safe and efficient provision of monopoly services. Airservices has achieved further efficiency gains over the term of the current pricing agreement, which are appreciated by industry. The more cost efficient the aviation industry can become, the better it is able to endure industry downturns and profit during periods of strong demand.

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<sup>2</sup> ICAO (2004), p. 18.

<sup>3</sup> Airservices Discussion Paper, p. 11.

Airservices, however, is not subject to the appropriate sanctions, rewards and accountability that need to be associated with route development. As noted by the Productivity Commission, government monopolies have key governance differences to private sector businesses:

As GTEs [Government Trading Enterprises] have stewardship of public monies, and particularly because the community 'owners' are unable to withdraw their capital, the parliament, auditors-general, media and the broader community question how efficiently and effectively those monies are being spent. Accordingly, GTEs are subjected to different operational accountability than the private sector.<sup>4</sup>

A decision by Airservices to underprice its services at a certain location is not subject to private sector evaluation (based on the overall change to profitability) and disciplines. This means that Airservices can entrench unprofitable and uneconomic services (even if the provision is reasonably efficient) without facing the appropriate loss in shareholder wealth. This is especially the case if the shortfall in funds can be recouped through the use of its market power at other airports or enroute services.

Airservices faces significant challenges going forward over both its people and investment in new technologies and services. Emirates is particularly concerned with the current availability of enroute separation services. The issue has reached a critical point where enroute services are regularly unable to be provided and airspace being declared TBIA (traffic information broadcast by aircraft) procedures.

In addition to maintaining current services, new technologies and services such as ADS-B, user preferred routes and tailored arrivals all offer potential to improve the efficiency and safety of aircraft operations.

In the long term, successfully meeting these challenges will provide major benefits to industry and should be Airservices' primary focus. Using its market power to promote the commercial viability of certain routes at the expense of others will at best 'rearrange the deck chairs' between airlines in terms of activity. It will more likely reduce the industry's overall efficiency and profitability. To best promote its legislative objectives, Airservices should focus on the critical issues associated with providing safe and efficient air traffic management services rather than become involved in the commercial decisions of airlines.

#### ICAO, National Competition Policy and the long term pricing agreement

ICAO pricing principles and Australia's NCP requirements provide a robust basis for setting prices. By following ICAO and NCP policies, prices are set in a way that promotes long run economic efficiency, is equitable between users and minimises the time Airservices must devote to price setting issues. Emirates would expect the final pricing proposal by Airservices to explicitly address how it is consistent with Airservices' international and national obligations.

The key ICAO pricing principles is that:

... the allocation of the costs of air navigation services among aeronautical users be carried out in a manner equitable to all users. The proportions of cost attributable to international civil aviation and other utilization of the facilities and services (including domestic civil aviation, State or other exempted aircraft, and non-aeronautical users) should be determined in such a way as to ensure that no users are burdened with costs not properly allocable to them according to sound accounting principles.<sup>5</sup>

The statement 'no users are burdened with costs not properly allocable to them' requires that prices be set on a location specific basis. That is, the amount of revenue obtained from each location should equal the cost of providing services at that location.

ICAO policies also acknowledge that governments may choose to 'recover less than full costs in recognition of local, regional or national benefits received'.<sup>6</sup> However, this does not mean ICAO supports overcharging international airlines to subsidise the provision of services at regional or general

<sup>4</sup> Productivity Commission (2005) Financial Performance of Government Trading Enterprises, 1999-00 to 2003-04, p. 49.

<sup>5</sup> ICAO (2004) ICAO's Policies on Charges for Airports and Air Navigation Services, Seventh Edition, p. 16.

<sup>6</sup> ICAO (2004), p. 8.

aviation (GA) airports. Rather, there must be an agreement between the provider and government over how the shortfall in funding is addressed.

In April 1995, all Australian governments reached agreement on a NCP for Australia. NCP is based on an explicit recognition that competitive markets will generally serve the interests of consumers and the wider community, by providing strong incentives for suppliers to operate efficiently and be price competitive and innovative.

Where competition is not possible, NCP Agreements require independent pricing oversight of significant government monopoly businesses. NCP Agreements state that price oversight advice should have the following characteristics:

its prime objective should be one of efficient resource allocation but with regard to any explicitly identified and defined community service obligations imposed on a business enterprise by the Government or legislature of the jurisdiction that owns the enterprise.<sup>7</sup>

The Agreements also states that the reform of public monopolies should also review:

the merits of any community service obligations undertaken by the public monopoly and the best means of funding and delivering any mandated community service obligations.<sup>8</sup>

In terms of efficient resource allocation for Airservices, this issue was subject to independent public review by the former Industry Commission (IC) (now the Productivity Commission) in its review of Intrastate Aviation. The IC found that for Airservices' services<sup>9</sup>:

... cross-subsidisation distorts production and consumption patterns and can impose considerable costs on the community..<sup>10</sup>

and:

... misleading prices affect patterns of supply and demand and, perhaps more importantly, can in the longer term result in inappropriate investment decisions by aircraft operators and infrastructure providers. For example, it is possible that subsidisation could lead to investment at airports which would otherwise not be undertaken. Such investment could be at the expense of other airports which have more economically-sound investment opportunities.<sup>11</sup>

The IC also recommended that:

...charges be modified so as to better reflect the differences that exist in services provided and the cost of their supply at different locations.<sup>12</sup>

Cross subsidies are therefore not consistent with the aims of NCP and the specific requirement of efficient resource allocation.

The finding of the IC in 1995 are still valid for today's aviation industry. Indeed, given the overall increase in the level of competition between airlines, cross-subsidies are likely to generate larger distortions to activity, competition and sound investments than in previous years.

Emirates appreciates that full cost recovery may not be possible at some regional airports and probably all GA airports. However, in Australia the issue of under recovery for certain services has been addressed across a range of infrastructure industries. It first requires Airservices to agree with the Australian Government both those services that will not be subject to full cost recovery and the level of cost recovery to be obtained. Funding of the shortfall could occur through either lower returns to Government or CSO payments. They should not occur through cross-subsidies from areas that fully cover their own costs.

#### Developments since the long term pricing agreement

The long term pricing agreement (LTPA) implemented on 1 July 2004 was an important step in setting prices consistent with ICAO recommendations and NCP requirements. The success of the agreement was well recognised, including by the Australian Competition and Consumer Commission (ACCC).<sup>13</sup>

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<sup>7</sup> Competition principles Agreement (1995), Volume 1 (as amended to 13 April 2007), p. 2.

<sup>8</sup> Competition principles Agreement (1995), p.5.

<sup>9</sup> Previously provided by the Civil Aviation Authority.

<sup>10</sup> Industry Commission (1995) Intrastate Aviation, Report no 25, p. 150.

<sup>11</sup> IC (1995), pp.73-74.

<sup>12</sup> IC (1995), p.151.

Since the implementation of the LTPA, however, there has been a move away from basing prices on costs. Instead, Airservices' appears to want to set ARFF and possibly TN prices based on its perception over the commercial viability of certain routes. This first occurred for ARFF services, and is a recurring theme throughout the discussion paper, particularly for TN services.<sup>14</sup> This shifts the focus of attention to the issue of income or 'rent' transfers between airlines rather than on the capacity, cost and quality of services.

If prices are based on perceptions over commercial viability, it is easier for an airline to improve profitability by simply lobbying Airservices to reduce prices at the locations they use (at expense of others airlines through over charging) instead of focussing on an efficient level of costs. This is a wasteful distraction of effort on the part of managers of both the airlines and Airservices. The more Airservices is drawn into influencing route profitability the less time is spent meeting the challenges Airservices faces in providing its core services.

In overcharging at major airports, it is also misleading to assume that international airlines have a high ability to afford inflated charges. Emirates' routes to Australia are marginal and our commercial opportunities and ability to successfully compete in Australia are influenced by the prices charged and quality of services provided by Airservices.

#### Airservices does not provide 'network' services

The key physical characteristics of networks are not observed in any meaningful form in the provision of enroute, TN or ARFF services. Airservices provides its services in accordance with ICAO requirements. It does not choose to operate unnecessary (in terms of ICAO requirements) loss making services because of the additional profits it can earn at other airports.

In terms of TN and ARFF services, costs occurring at one airport are the responsibility of traffic at that airport only. For example, costs incurred at Sydney, Melbourne and regional airports are irrelevant to the costs of serving international airlines that operate to Perth airport. The Productivity Commission also noted that there are few common costs in the provision of ARFF services:

... in the Commission's view, Ramsay pricing principles do not seem particularly relevant in the case of ARFF services, given that common costs across different airports are unlikely to be significant.<sup>15</sup>

Network-based charges are not justified based on cost causality between airports.

It is worth noting that in most overseas countries, including the United States, United Kingdom and New Zealand, ARFF services are provided by individual airports rather than by a single provider across all airports.

Airservices' ability to impose uniform prices flows from its market power, which is derived through legislation. It is not because there is an economic justification for network charges.

The reality is that the airlines, and not Airservices, determine the extent of any networks, and these occur in the final transport services provided to passengers. Airlines may choose to maintain a capacity and frequency on routes that is not commercially justified on a 'stand alone' basis because of the value it offers to the network. But this is a commercial decision for the airline and not one that Airservices should seek to influence.

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<sup>13</sup> See for example, Graeme Samuel (14 Nov 2005), Speech to the Australian Airports Association, Airports and Aviation Outlook, p. 3.

<sup>14</sup> See for example, Airservices' Discussion Paper, p. 9 and 21.

<sup>15</sup> Productivity Commission (2006), Review of Price Regulation of Airport Services, p. 131.

### **3 Response to specific questions**

- 1) What is the appropriate mechanism for Airservices Australia's charges and to what extent is it desirable to allow airlines to negotiate directly with Airservices for the provision of services?**

Emirates prefers a continuation of the current arrangements where services are priced after appropriate consultation with industry and review by the ACCC (if prices need to increase). This reflects Emirates' position that price setting need only be concerned with recovering efficient costs. A move to individual negotiation is not supported. It will lead to a reduction in transparency over the financial terms offered to individual airlines.

**Do you have a preference for the length of the agreement?**

Prices for regulated services should be set for a five year period. A five year price path encourages cost efficiency and minimises regulatory costs.

- 2) What are the appropriate charging thresholds for Airservices' services?**

For locations served by RPT airlines, it is not unreasonable to assume the incremental cost associated with serving small, non-RPT aircraft is low. A charge is still justified because a service is being provided. However, it is not unreasonable for charges for small non-RPT aircraft to be modest.

- 3) Is an 'access fee' an appropriate means of charging for smaller aircraft? If so, what amount would be reasonable, or is the current Light Aircraft Option effective in reducing administrative complexity?**

Emirates has no objection to charging an 'access fee' for small non-RPT aircraft.

- 4) How could Airservices objectively measure service quality for reward or penalty?**

Emirates has concerns over the current level of service quality, particularly the availability of enroute services. If services are not provided to the specified standard, a rebate should apply.

Emirates suggests that the rebate be set at 50 per cent of the cost of the service if the service is not provided for only part of the flight. This makes the rebate amounts more meaningful in terms of Airservices' revenues. The cost impost on efficient aircraft operations from the unavailability of services exceeds the prices paid to Airservices for the service.

- 5) Is it desirable for Airservices to commercially negotiate specific value-adding services with customers?**

See comments under question 1.

- 6) Are weight and distance appropriate bases for charging? If so, should weights and distances be fixed, or vary according to the actual route being flown?**

See comments under enroute, TN and ARRF pricing.

- 7) For enroute charges, is a change in the charging threshold to target RPT aircraft (as defined for charging purposes) desirable?**

See comments under question 1.

- 8) For enroute services, is it desirable to separate the Indian Ocean (or any other piece of oceanic or continental airspace)?**

See comments on enroute pricing.

- 9) For terminal navigation charges, is a change in the charging threshold to target RPT aircraft (as defined for charging purposes) desirable?**

See comments under question 1.

- 10) For terminal services, how should the current price caps change over time?**

See comments on TN pricing.

**11) For terminal services, is any further pooling of costs desirable?**

Emirates opposes any pooling of radar approach costs based on either network or ability to pay arguments. Radar approach services should be priced on a location specific basis.

**12) For ARFF services, should emergency responses to terminals and airport tenants be charged separately?**

Emirates supports the 'user pay' principle and as such airport tenants who use the services of ARFF should be charged accordingly.

**For ARFF services, should the base-level charge be adjusted automatically when a new service is introduced?**

Increasing base-level costs for all airports when a new service is introduced is a form of network charging and contrary to ICAO pricing principles.

In its discussion paper, Airservices states that under its approach to pricing, 'the price for a particular service should cover its direct or marginal cost, and preferably make a contribution to overheads and return'.<sup>16</sup> The marginal cost of a new service at a location is clearly the full incremental or additional cost of the service. Underpricing new ARFF services through the pooling of costs across airports is contrary to Airservices stated pricing principles.

**14) For ARFF services, should a change in the category of an airport result in an automatic change in the price at that location?**

See comments under ARFF pricing.

**15) To what extent is it desirable for airlines to negotiate directly with Airservices for the provision of services?**

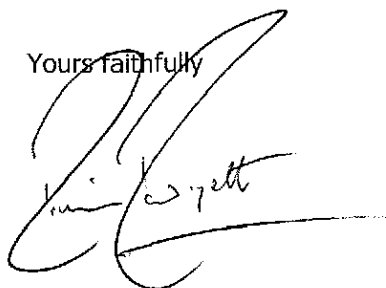
See comments under question 1.

**16) What alternative risk sharing arrangements might the industry wish to pursue?**

The current risk sharing arrangements provide mechanisms for possible price adjustments and rebates should actual outcomes differ significantly from forecasts. Such arrangements should continue and be extended to cover situations where the level of actual capital expenditure is significantly less than the level forecast in the LTPA.

Thank you for the opportunity to comment on Airservices' 2008 discussion paper on pricing structures for its regulated services.

Yours faithfully



Robin Padgett  
Vice President Procurement (Airline)

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<sup>16</sup> Airservices Discussion Paper, p. 47.