



Terminal Navigation (TN) Pricing Review

Submission by Singapore Airlines, 26 July 2010

Singapore Airlines (SIA) has reviewed the submissions to Airservices Australia's (AsA) Terminal Navigation (TN) Pricing Review Discussion Paper. SIA did not provide an initial submission as the position of international airlines was well advocated in the submission by the Board of Airline Representatives Australia (BARA).

SIA supports a continuation of location specific pricing (LSP). SIA is prepared to pay its reasonable share of TN costs at airports to which it operates, but SIA should not be expected to pay for unrelated and unused TN services at regional locations.

SIA is concerned about submissions to AsA that evaluate the relative merits of different pricing structures based on wrong and/or poorly applied cost concepts and simplified market conditions. In particular, SIA considers that the submission by Qantas Airways (Qantas) contains flawed cost concepts (at least in their application) and highly unrealistic market conditions to justify a return to network pricing.

SIA's concerns over the Qantas submission and its support for a return to network pricing are detailed below.

Variable and fixed costs and Pricing Option Number 4

Qantas has expressed its support for a variant of Pricing Option 4 'Location Specific Variable Costs with Fixed Cost Network Charge'. Under this Option, staff costs are considered 'variable', while all other costs are defined as 'fixed'. Variable costs are recovered on an airport-by-airport basis, while fixed costs are recovered on a network basis.

It would appear that Qantas has accepted the definition of variable and fixed costs contained in Option 4 at face value. The Qantas submission argues that TN prices at each airport must at least recover 'the costs that are directly attributable to their supply decisions.'¹ However, no explanation of what directly attributable costs are in practice is provided. Instead, Qantas states that:

Part 1 of the tariff involves setting a charge that is specific to particular aerodromes that permits the recovery of variable costs (essentially the first part of option 4).²

SIA would interpret this as acceptance by Qantas that AsA's staff costs can be considered variable and all other costs fixed.

¹ Qantas Airways (June 2010), A Submission in Response to the ASA Discussion Paper 'Terminal Navigation Pricing Review', p. 4.

² Qantas Airways (June 2010), p. 4.





Application of Option 4 would result in full network pricing

No justification is provided in AsA's *Discussion Paper* as to why staff costs should be considered variable and all other costs fixed. This is not surprising because where AsA has drawn the line between variable and fixed costs in Option 4 is arbitrary.

For example, on any particular day, all TN costs (staff, routine maintenance, etc) can be considered fixed and the variable cost zero. No costs vary with the additional (or 'marginal') landing or take-off of an aircraft. The only possible variable costs that could occur are for aircraft that land outside normal operating hours, thereby requiring extended operating hours at the airport.

Taken to its logical conclusion, Option 4 would mean AsA recovers all of its costs through a network-based charge. Staff costs are no more variable than the capital equipment used to provide TN services to individual aircraft. All costs could therefore be considered fixed for pricing purposes.

The appropriate cost concept is avoidable cost

The correct concept for determining directly attributable costs is not variable and fixed costs, but rather 'avoidable' costs. The Australian Competition and Consumer Commission (ACCC) and former Prices Surveillance Authority (PSA) have endorsed the concept of avoidable costs in examining prices for telecommunications, postal services, airports (the former Federal Airports Corporation) and railways.³ It is also the concept used to determine if a government agency has taken unfair advantage of its government-ownership position when competing with the private sector.

The Commonwealth Competitive Neutrality Complaints Office (CCNCO) defines avoidable cost as:

...all costs the agency would save, or avoid, if the business ceased operating. This includes the resources used exclusively by the unit, and the additional cost the agency incurs to provide resources to the unit.⁴

Critically, avoidable costs are measured over longer time periods. Avoidable costs recognise that infrastructure services involve long lived assets. This allows for future investment to be included in the analysis, rather than only the marginal cost of providing TN services to an additional flight. As stated by the CCNCO:

In choosing an appropriate time period, it is important to recognise the underlying objective of competitive neutrality — that is, better resource allocation. Resources will be efficiently allocated if government business units set commercial prices. This requires prices which, over

³ See for example: ACCC (2002) Australian Postal Corporation, Price Notification, Decision; ACCC (2004) Final Report – 2004 Review of Telstra Price Control Arrangements; PSA (1993) Inquiry into the Aeronautical and Non-aeronautical Charges of the Federal Airport Corporation.

⁴ Commonwealth Competitive Neutrality Complaints Office (1998) Cost Allocation and Pricing, CCNCO Research Paper, Productivity Commission, Canberra, October, p.viii.





time, cover not only operating costs, but also provide a return on capital. To ensure that capital and other longer term costs are treated as potentially avoidable (and therefore included in the cost base) a medium to longer term perspective should be taken.

Nonetheless the precise period is likely to differ depending on the type of activity. It will obviously be longer for an activity with long-lived infrastructure assets than for an activity where labour is the predominant cost.⁵

AsA is seeking to enter into a five year pricing agreement with airlines. Avoidable costs are, therefore, most practically measured over the period of the pricing agreement. Avoidable costs would, therefore, include:

- all recurrent costs, eg staff and general maintenance,
- all planned capital expenditure at each airport – this includes both replacement capital and investments to expand or enhance capacity,
- the value of any capital equipment that could be transferred to another location,
- the value of any buildings or land that could be sold to the airport operator or other interested party.

The only remaining ‘unavoidable’ or ‘sunk’ costs would be the capital equipment, buildings and land of no value in any other alternative use. AsA’s directly attributable costs at each airport are, therefore, far higher than staff costs. Indeed, they are likely to represent the vast majority of total costs in most instances.

Common ownership does not justify networking sunk costs

Given that some costs are sunk, it is necessary to determine how these costs are to be recovered from users. In particular, should they be recovered from the aircraft that operate to the airport or be distributed across all airlines based on perceptions over each airline’s ‘ability to pay’?

There is no justification to network sunk costs based on the argument that AsA is providing a network of TN services. Networks are characterised by hub and spoke arrangements, which do not exist in any meaningful way in the provision of TN services.

Instead, as a legislated monopoly provider of TN services across Australia, AsA can use its market power to redistribute costs across airports. The question, therefore, is whether AsA is uniquely placed to improve Australia’s economic welfare by shifting its sunk TN costs around Australia’s major and regional airports.

Simplified application of ‘Ramsey’ pricing principles will fail in practice

The argument supporting networking sunk costs is that the capacity and/or frequency of flights by domestic airlines to regional locations will be disproportionately reduced for a

⁵ CCNCO (1998), p.15





given increase in TN prices. As such, it is argued that more efficient outcomes (as measured by total airline activity) can be obtained by reallocating the sunk costs incurred at regional airports to major capital city airports.

Qantas argues that fixed costs should be allocated in a way that equalises the price elasticity of demand for TN services across airports.⁶ By assuming the slope of the demand curve is the same across all airports, Qantas argues that aircraft operating to major city airports should actually pay a higher network price per tonne compared to smaller regional airports.⁷

A major problem with 'Ramsey' pricing for TN services (apart from the fact it cannot be justified by network characteristics) is that no one claims to have any meaningful understanding of the responsiveness of airlines to changes in TN prices across airports. AsA has stated that it does not know the price elasticity of demand for TN services.

Without any reliable information, advocates of network pricing must resort to highly simplified market conditions, such as that suggested by Qantas. However, such simplified assumptions tend to grossly overstate the likely actual differences in the price elasticity of demand between major and regional airports. As a consequence, the actual difference network pricing will have on airline decisions is also highly overstated.

Differences in the price elasticity of demand across airports are usually overstated because the responsiveness of airlines to changes in TN prices should be assessed on a network rather than stand-alone basis. Networking by the airlines acts to reduce the overall responsiveness of major domestic airlines to changes in TN prices at regional locations.

In Australia, the major domestic airlines provide a network of services to passengers. While there is often a degree of segmentation within the overall airline group (eg Jetstar within Qantas), ultimately decisions to expand or reduce capacity to a particular airport are based on the value of each flight to the overall network.

This means that shifting costs around an airline's domestic network will not necessarily alter its decisions over the capacity and frequency of flights (or the prices charged to passengers). It will depend on the extent to which passengers from the thinner routes provide feeder traffic to other routes on the network. An airline may choose to retain a loss making route on a stand-alone basis because of the value it provides to the overall network.

Another reason why the purported benefits of network pricing fail in practice is because Australia's smaller airports are characterised by a large diversity of traffic mixes. Some relatively small airports are likely to have highly inelastic demand due to a high proportion of business passengers (eg Canberra Airport and airports used by large mining companies to fly workers out to mine sites). The diversity of Australia's smaller airports further undermines the usefulness of applying simplified market conditions.

Networking sunk costs in practice – rent transfers and uneconomic services

⁶ Qantas Airways (2010) p. 9.

⁷ Qantas Airways (2010), p. 9





AsA can have little confidence any simplified application of Ramsey pricing principles will lead to an improvement in short run economic efficiency by increasing total airline activity. Instead, network pricing is advocated by domestic airlines because it reduces their total annual payments to AsA. In the longer term, it will encourage an expansion of uneconomic services at regional locations. Unwinding uneconomic services at some point in the future will cause considerable hardship for workers who either lose their jobs or accept relocation. On the other hand, by persevering with LSP, AsA will ensure that it contributes to an efficient industry by investing where users value the TN services more than the cost of its provision.

