

Airservices Australia Long Term Pricing Agreement

Discussion Paper April 2015

**Submission by Australia Pacific Airport Corporation
(APAC)**

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INTRODUCTION

APAC acknowledges the progress made by Airservices in aiming to move towards a more cost reflective pricing mechanism, while managing the consequential price shocks from any such changes.

This has occurred in the context of the regulatory price setting framework and Airservices willingness to consult and work with the industry as a whole and with individual stakeholders to deal with specific needs and innovative proposals.

APAC has provided its views in relation to specific questions raised by the Discussion Paper in turn below.

1. Pricing principles: Do Airservices pricing principles sufficiently capture the interests of industry in targeting an equitable and efficient pricing outcome?

The application of the pricing principles for Airservices has resulted in what may be described as a socially equitable pricing outcome, but not necessarily an economically efficient outcome. Business and leisure travellers flying on major commercial airlines through major capital city airports make up the overwhelming majority of air travel within Australian airspace. However, the application of the pricing principles results in a cross subsidy from commercial air travel consumers to fund the activities of general aviation and smaller airports.

APAC understands the conflicts between managing price shocks, cost reflectivity, and the interests of users with a lower capacity to pay. However as the Australian Competition and Consumer Commission (ACCC) has previously pointed out, such criteria must be balanced to ensure that cost recovery is maintained while the distortion to allocative efficiency is minimised.

This distortion comes at the expense of domestic and international passengers flying through major Australian airports. This is through the application of a range of different tariff mechanisms outlined below.

Pricing categories by Maximum Take Off Weight (MTOW) for enroute tariffs

As identified in by Cathay Pacific and British Airways in previous submissions, the size of an aircraft is largely unrelated to the costs incurred by Airservices in providing enroute services. However, MTOW continues to be used in determining prices paid by airlines. This results in larger aircraft being charged more and appears unconnected to the actual cost of providing services to those larger aircraft.

It is arguable that larger aircraft are subjected to higher prices for homogenous services on the basis that more passengers and freight provide a better opportunity

to absorb and spread the costs over a larger number of customers. This operates as a cross subsidy, and is inconsistent with the principles of cost reflectivity and undermines allocative efficiency.

Cross subsidy between enroute tariffs and terminal charges

The use of MTOW in charging for enroute services is compounded by higher enroute charges than necessary to cover the cost of the service, effectively smoothing a location specific charge into a network charge. Aircraft flying longer distances, in particular major international carriers, have been cross subsidising the costs of terminal charges.

Cross subsidies between smaller airports and larger airports within the basin charging framework

While we appreciate the difficulty in accurately forecasting demand for Airservices at smaller airports and setting prices accordingly, the current framework results in ongoing long term cross subsidies between smaller metropolitan and regional airports at the expense of larger and more efficient airports. Sudden changes in activity at smaller airports would result in sudden changes in prices from one period to next, if a building block approach were used for each airport.

However, the current arrangement means that larger and more efficient airports are used as an averaging mechanism to smooth the volatility in costs at smaller airports. Over the long term the price smoothing, which occurs as a result of the basin pricing approach, effectively entrenches ongoing subsidies.

This arrangement is neither efficient nor equitable. Large up front infrastructure costs and major operating costs of running terminal services at smaller airports are levied predominantly on domestic and international air travel consumers flying through a different airport. Airlines and final consumers at these smaller airports do not face the actual costs of the provision of the infrastructure due to these cross subsidies, and operations which are structurally inefficient continue to operate.

Broader social policy objectives

Based on the ongoing cross subsidies between MTOW, enroute, and location specific costs, the Airservices pricing principles appear to be applied primarily in promoting government objectives for minimising price shocks, economic development (particularly in the regions) and supporting the small scale and recreational aviation sector.

The principle of allocative efficiency is clear on this issue: the economically efficient outcome is reached when all users are charged in accordance with the costs they impose on the network. If State or Commonwealth governments find the economically efficient outcome undesirable for wider social policy reasons, then State or Commonwealth governments should fund these activities directly and transparently through a community service obligation (CSO) payment.

If State or Commonwealth governments are unwilling to fund these activities through a CSO payment, then these cross subsidies should be removed.

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

An investigation into the use of performance incentives for improved service delivery and efficiencies made by Airservices which may lead to material improvements to airport operations would be of value. The pricing framework provides an incentive for Airservices to deliver efficiency gains within the pricing agreement period for its own costs, but we would note that Airservices can have significant impacts on running an airport or an airline which aren't reflected in the current pricing agreement incentives.

Where it is possible for Airservices to improve the operational efficiency of its customers without compromising on other objectives (most obviously, safety), then Airservices should be encouraged to find and deliver those efficiencies on an ongoing basis. Airservices should also be encouraged to do this promptly.

We note the issue of performance incentives was raised by the ACCC in the previous Airservices Australia price notification (June 2013) with a commitment to a new Services Charter in 2013-14¹. However, the current 2015-16 Services Charter is silent on performance incentives, and has not been addressed in this discussion paper beyond reference to the implementation of new technology by the aviation community outside of Airservices.

For example, we note the implementation of the ACE program. In our view, programs such as this should be the norm for Airservices, rather than the exception.

11. Alternative mechanisms: What alternatives to the current basis of charging, should Airservices consider including as part of its pricing framework?

The discussion paper points to many issues which result from blending network costs (costs incurred in operating a network which benefits the broader consumer group), and customer specific costs (costs incurred in providing a service which benefits one identified group of consumers). The parallel is clear: terminal assets and services which are located at a specific airport and cannot be moved would appear to constitute customer specific costs, and services provided for enroute and navigation services would be best considered as network services.

In most other regulated industries, customer specific costs are managed through customer contributions and connection charges incurred up front and in full, while operating and maintenance costs are recovered through network charges. In our view this is the most efficient and equitable way to recover costs for location specific assets with minimal cross subsidies and considerably reduced price volatility for smaller airports.

¹ Airservices Australia price notification ACCC decision June 2013, page 9.

Establishing a funding mechanism for services provided outside the major gateway airports which resembles the connection charge basis would seem to present an efficient and equitable alternative to the current model. This approach has operated successfully in other contexts and is analogous to funding an electricity connection to a wind farm, or a new suburb built at the fringe of the existing electricity network.

Considering costs in this way would clarify many themes which run through the discussion paper. In principle, new assets built to the benefit of one group of users at one location should be recovered through a connection charge levied on those users and in so doing remove the need for complicated stranded asset recovery mechanisms.

This principle for location specific pricing has been supported elsewhere by the ACCC. In addition to standard regulatory practices used in electricity, gas, and water regulatory regimes, the ACCC had a strong preference for location specific charges as reflected in its December 2004 Final Decision on Airservices Price Notification².

“A return to a network pricing approach is unlikely to advance either efficient or equitable outcomes.

While the demands for services at different airports are to some extent inter-related, the services which Airservices supplies are not network services in the strict functional sense, as tends to be the case for electricity, telecommunications and gas transmission.

While a uniform pricing approach between locations may cause relatively small losses in allocative efficiency, given the relative inelasticity of demand of major airport users, network pricing may have negative consequences for productive efficiency. Productive inefficiency may be more likely to result at smaller locations if excessive expenditure by Airservices is not required to be recovered from the users at that location, but is instead funded by the revenue received from larger airports.

There is also an equity argument for requiring each location to be self-funding, so that customers are not required to pay more than the cost of providing the service to them. “

As it has previously stated APAC supports location based charging for relevant Airservices activities and opposes use of network pricing which sees users of one service paying for the benefits accruing to other users elsewhere in the network.

² ACCC Final Decision Airservices Australia Price Notification Dec 2004 p130 -131