General Counsel
Brett Johnson

18 December 2006

Ms Jill Irvine
Productivity Commission
PO Box 80
Belconnen ACT 2616

Dear Ms Irvine

Price Regulation of Airport Services - Commission Inquiry

We refer to the Productivity Commission's (PC) hearing in Sydney on 30 October 2006 in relation to its inquiry into airport services and the questions the PC had for Qantas Airways Limited (Qantas) on the impact of fuel surcharges and airport charges on demand.

At the hearing, the PC asked for Qantas' view of whether airport charging is affecting the price of air tickets and how often people travel, or whether airlines are just complaining about a 'rent distribution' issue between the profitability of airlines and airports.

Before responding to the PC's questions, it is important to note that Qantas is not arguing that high airport charges are the primary concern airport users have about Australian airports under the current prices monitoring system. Qantas' concerns are not solely about price or how airports have behaved in the past.

Rather, Qantas' main concern is that major Australian airports are monopoly service providers and, as such, airport users have no choice but to use the facilities and services provided by the airport operator at a given destination. In such an environment competitive outcomes cannot be achieved without the parties having some recourse to binding dispute resolution when negotiations fail. This problem relates to both price and non-price terms and conditions of supply.

Set out below is our response to the specific questions raised by the PC.

Impact of Airport Charges

The PC questioned the airlines' ability to 'pass on' airport charges to customers. That line of questioning appears to be directed to arguments that:

- airport charges are small relative to the total price of an airfare, such that an increase in airfares as a result would not impact demand (the PC expressly compared the $31 domestic fuel surcharge with an approximate $3.50 Sydney Airport landing charge[1]); and

- airlines are able to pass such charges on to their customers without suffering revenue implications.

As elaborated below, those arguments were rejected by the Australian Competition Tribunal (Tribunal) in *Re Virgin Blue Airlines Pty Ltd* on the basis of the hard evidence put before the Tribunal and extensive economic analysis.

[1] Productivity Commission, Inquiry into Price Regulation of Airport Services, Transcript of Proceedings, 116.

Airport Charges Not Small

Airport operators often contend that landing charges are small relative to the total price of an airfare and therefore an increase in airfares as a result of an increase in landing charges would not impact on demand. However, when making a comparison between airport charges and airfares, it is important to remember that:

- landing charges are only one of a range of fees and charges (including terminal charges, ground handling fees, aircraft parking charges and fuel throughput fees) airlines must pay to an airport in relation to operating a passenger aircraft to and from that airport; and

- air travel requires a plane to both depart from its origin and land at its destination – charges apply at both. Adopting a single landing charge at one airport as a basis for analysis fails to comprehend the magnitude of all airport charges payable to operate a flight.

Therefore comparing the relativity of airport charges to the total price of the airfare is not a particularly useful comparison. Rather it is the magnitude of airport charges relative to the profitability of a route that is important (for example, in relation to decisions about routes and capacity).

The evidence of Mr Smart before the Tribunal showed that, when regard is had to the elasticity of demand for air passenger travel and the magnitude of airport charges relative to the profitability of a route[2]:

- 'relatively modest increases to the Sydney Airport Airside Service would make the current level of profitable Qantas activity on some routes unprofitable; and

- relatively modest decreases to the Sydney Airport Airside Service price would make the current level of unprofitable Qantas activity on some routes profitable.'

Airlines Unable to 'Pass On' Charges without Revenue Implications

The Tribunal in *Re Virgin Blue Airlines Pty Ltd* rejected Sydney Airport Corporation Limited's (SACL) arguments that[3]:

(a) a small increase in landing charges would be unlikely to impact on a passenger's decision to fly or an airline's business decisions[4]; and

(b) the introduction of fuel surcharges by both Qantas and Virgin Blue Airlines Pty Ltd ('Virgin Blue') evidenced an airline's ability to pass on any increase in airport charges without revenue loss to the airline or other negative consequences for competition in the dependent market[5].

In rejecting SACL's argument that an airline can simply pass on charges without incurring revenue loss, the Tribunal had the benefit of hard evidence in the form of highly confidential information of both Qantas and Virgin Blue as to the impact of charges on their yield. As such material is highly commercially sensitive, Qantas does not propose to repeat the exercise already undertaken for the Tribunal as part of a public process. However, some of the evidence put before the Tribunal and the Tribunal's findings are set out below.

Qantas led evidence, which was accepted by the Tribunal, that it could not merely pass on any increase in airport charges to passengers, without impacting demand or yield. In his statement, William Owens (Qantas' Head of Domestic Pricing and Yield), commented that:

> 'because Qantas already deploys exhaustive yield management techniques for each flight on each route, there is no basis upon which increases in the costs of

[2] Statement of Michael George Smart, 10 September 2004, 32, [125].
[3] (2005) 195 FLR 242, [561]-[568].
[4] (2005) 195 FLR 242, [540].
[5] (2005) 195 FLR 242, [561]. Qantas had introduced a $6 fuel surcharge on domestic tickets from 18 May 2004 and Virgin Blue had later also levied a $6 fuel surcharge.

aeronautical services can be fully passed on or offset by decisions to increase prices or further adjust classes of passengers and ticket conditions'[6].

This also explains why Qantas has been unable to fully recover its increased cost of fuel from passengers. According to the evidence provided by Mr Owens[7] and Qantas' public statements[8], the fuel surcharge applied by Qantas does not fully recover the increased cost of fuel to the Qantas Group. The shortfall is in part driven by an assessment of the potentially adverse impact fuel surcharges have on demand as well as the practice that purported increases in ticket prices are competed away given the high level of competition between airlines for the marginal passenger.[9]

The Tribunal also accepted evidence that, during the period of Virgin Blue's $6 fuel surcharge, its average fare had decreased (but for a marginal increase on the Sydney-Canberra route). The Tribunal commented[10]:

> 'What occurred was that, in order to sustain demand and maintain acceptable load factors, Virgin Blue was obliged to offer more tickets in cheaper fare buckets. No doubt it can be said that the reduction in demand for tickets was attributable to a number of factors …. Nevertheless, the fact is that immediately after the first fuel surcharge was implemented, demand for Virgin Blue tickets was reduced and average fares were reduced.'

This is not a surprising conclusion when one considers that airlines apply yield management techniques to maximise yield to the fullest extent possible. An independent expert witness called by Qantas, Henry Ergas, considered whether airlines can use yield management or other forms of price discrimination to minimise the effects of higher input costs, including airport charges[11]. He commented that 'for a given level of demand, if an airline is already applying yield management techniques, airport charges will not simply be absorbed without a reduction in consumption and/or airline profitability'[12].

Only a monopoly service provider, like a major airport, can simply pass on any increase to its customers without implications for revenue or demand.

Rent Distribution

The PC also questioned whether airlines are just complaining about a 'rent distribution' issue between the profitability of airlines and airports.

Qantas has never suggested that airport owners should be prevented from making a profit on their investments. However, airports need to be constrained from seeking to maximise their profits at the expense of airlines and the travelling public.

Please do not hesitate to contact me or Jill Henderson, Deputy General Counsel – Competition (on 02 9691 5799), if you have any questions.

Yours sincerely

Brett Johnson
General Counsel

[6] Statement of William Owens, 30 June 2004, 15, [54].
[7] Statement of William Owens, 13 August 2004, 3, [10 – 12]
[8] Qantas Media Release, 'Qantas to Increase Fuel Surcharge', 26 April 2006.
[9] Statement of William Owens, 13 August 2004, 3, [16].
[10] (2005) 195 FLR 242, [563].
[11] Statement of Henry Ergas, 10 September 2004, 49.
[12] Statement of Henry Ergas, 10 September 2004, 58, [252].