PRICE REGULATION OF AIRPORT SERVICES

VIRGIN BLUE SUBMISSION TO PRODUCTIVITY COMMISSION INQUIRY

3 MARCH 2001

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OVERVIEW

Virgin Blue has undertaken substantial investment to establish a competitive low-fare airline in Australia and has established a significant presence in the Australian airline industry. Virgin Blue's entry has dramatically reduced fares on the routes it operates and expanded the overall demand for air travel.

Virgin Blue is dependent on the availability of efficient low cost airport facilities to sustain its competitive strategy. Accordingly, airports are key partners for Virgin Blue and low fare airlines generally in ensuring a low fare environment for the travelling public.

Airports benefit from the commercial risk taking of new entrant airlines and new entrant airlines are dependent on access to airport sites and facilities. While the interests of airports and airlines in a broad sense are aligned, airports maintain substantial market power, due to the lack of competitive alternatives. As such, price and general economic regulation of airports is essential to keep costs down, to keep fares down and to maintain a viable environment for new airline investment.

Virgin Blue's experience to date is that airports retain significant market power and are able to charge prices which are significantly above the cost of providing an appropriate level of service to Virgin Blue.

Reliance on access rights for airports price regulation is inefficient and costly. As with other natural monopoly industries, such a electricity and gas transmission, explicit price regulation is required.

Sensible regulation should provide scope and incentives for airports to provide facilities and services appropriate for low fare operators. Access to airport facilities should be available at low cost and not subject to substantial uncertainty. However, the current framework for price regulation is poorly defined, uncertain and costly (for all participants), particularly with respect to the necessary new investment provisions. The current regime leaves substantial scope for airports to be opportunistic.

Future price regulation of airports is necessary and should, as a minimum, cover:

- capital cities and other major airports;

- all services provided by airports which are inputs into the provision of commercial aviation services.

In general, Virgin Blue supports the continuation of CPI-X price cap regulation. However, new investment should be explicitly considered in relation to the setting of future CPI-X price caps. There should only be limited scope for passing through charges for new investment outside of the CPI-X cap. That is, where such investment would not otherwise occur and is consistent with the requirements of users.

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1. VIRGIN BLUE

Virgin Blue is a low fare airline owned and operated by Virgin Blue Airlines Pty Limited. Virgin Blue's competitive strategy is to provide efficient, reliable and friendly air travel at a low fare by removing unnecessary additional operating costs, such as the maintenance of large and expensive terminals, airport lounges, frequent flyer programs, 'free' meals, high cost marketing and distribution systems, and the additional cost of maintaining different types of aircraft.

Virgin Blue has access to substantial experience in the airline industry as part of the worldwide group of Virgin companies owned and controlled by Sir Richard Branson. The Virgin group currently operates 3 other successful airlines: [1]

- Virgin Atlantic Airways. Virgin Atlantic Airways is one of the worlds premier international airlines. It commenced operations in 1984 and currently operates 27 aircraft including Boeing 747, Airbus 340 and A320 aircraft. Its turnover in 2000 was in excess of $3 billion. In 1999, Singapore Airlines acquired 49% of Virgin Atlantic Airways for in excess of $1.5 billion.

- Virgin Express. Virgin Express is a low fare airline with an Air Operating Certificate from Belgium. Virgin Express currently operates 13 Boeing 737 aircraft to 10 major European destinations such as Brussels, Milan, Rome, Berlin, Copenhagen, Malaga, Barcelona, Madrid, Nice and London's Heathrow airports.

- Virgin Sun. Virgin Sun is a division of Virgin Atlantic Airways and operates 3 charter aircraft out of the UK.

Virgin Blue provides low-fare domestic passenger services to and from Brisbane, Sydney, Melbourne, Adelaide and Townsville airports.

- On 31 August 2000, Virgin Blue commenced its domestic passenger service, servicing the Brisbane-Sydney and Brisbane-Melbourne routes. Currently, Virgin Blue operates 16 flights per day between Brisbane and Sydney and 10 flights per day between Brisbane and Melbourne;

- On 7 December 2000, Virgin Blue commenced operating on the Brisbane-Adelaide route. Currently, Virgin Blue operates 4 flights per day between Brisbane and Adelaide;

[1] For more general details of the Virgin group of companies, please visit www.virgin.com.

- On 1 March 2001, Virgin Blue commenced operating on the Adelaide-Sydney route. Currently, Virgin Blue operates 6 flights per day between Sydney and Adelaide; and

- On 15 March 2001, Virgin Blue commenced operating on the Townsville-Brisbane route. Currently, Virgin Blue operates 2 flights per day between Brisbane and Townsville.

Virgin Blue operates a fleet of 6 Boeing 737-400's with a seating capacity of 162. The company has grown from its inception 12 months ago to the present having in excess of 600 employees and expecting to turnover in excess of $150 million.[2]

The company is committed to a further 14 new generation 737-700 & 800 aircraft over the next 19 months with the first two to be delivered in April 2001.

Virgin Blue operates out of the following domestic airport terminals:

- the Brisbane Domestic Terminal owned and operated by Brisbane Airport Corporation Limited;

- the Domestic Express Terminal owned and operated by Sydney Airport Corporation Limited at Kingsford Smith Airport;

- the Domestic Express Terminal owned and operated by Australian Pacific Airports (Melbourne) Pty Ltd (APAM) at Melbourne Airport;

- the Adelaide International Terminal operated by Adelaide Airports Limited;

- the Townsville International/Domestic Passenger Terminal operated by Australian Airports (Townsville) Limited.

[2] For further information, please visit our web site www.virginblue.com.au.

2. COMPETITION IN THE DOMESTIC AIRLINE INDUSTRY

Virgin Blue's strategy is to position itself as the lowest cost producer of air travel services in Australia. Virgin Blue's strategy is to offer a low price on all its fares, together with quality service, in order to attract an increasing number of passengers to air travel. Virgin Blue's strategy can be distinguished from the strategic approaches adopted by Qantas, Ansett and Impulse.[3]

On each of the routes on which it operates, the Virgin Blue standard fare is substantially below the standard Qantas and Ansett fares. Relevantly:

- Virgin Blue does not structure its fares to require advance purchase of tickets, or a length of stay to access the budget fares. Qantas and Ansett have responded by offering tickets without these conditions.

- Virgin Blue offers fare savings to customers who book on-line to reflect the lower cost of this method of booking. Qantas and Ansett have now sought to increase the number of fares booked on-line.

- Virgin Blue introduced budget fares of $39.00 for Sydney/Brisbane, $96.80 Melbourne/Brisbane and $108.90 for Adelaide/Brisbane. Qantas and Ansett have responded with budget fares.

- On budget air fares, the fares charged by Virgin Blue more than halved those charged prior to the entry of Virgin Blue and Impulse. For example, on the Melbourne/Brisbane route the fare was $222.20 and is now $96.80. Qantas and Ansett's business class and fully flexible (corporate) fares are still substantially higher.

Virgin Blue's strategy is to price air travel at a level which is readily affordable for most people. Virgin Blue has sought to price its fares at levels which will attract travellers who may otherwise have travelled by bus, train or private car, and to expand the overall demand for air travel by making it more affordable for those who otherwise could not afford to fly.

This strategy has been very successful overseas for many European and other airlines. These include Southwest Airlines in the USA, Westjet in Canada, and Easyjet & Ryanair in Europe. All have experienced rapid growth, and have carved out places in those markets as low fare carriers. In each case, the market has grown substantially as the low fares have caused passengers to fly who would not have previously contemplated air travel at the formerly high prices.

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[3] As an example of Impulse's different strategy, it has recently introduced a frequent flyer program. Impulse offers 'extras' to their passengers including newspapers and basic refreshments and, when possible, offer aerobridge access to their planes. Impulse is also positioned as a regional airline. Impulse also seeks to provide a higher standard of terminal facility than that sought by Virgin Blue.

In Australia, this strategy has also been highly successful with a huge growth in passenger travel by all relevant measures. The Commonwealth Department of Transport and Regional Services publishes the *Domestic Airline Monthly Report*. The Report dated 23 March 2001 demonstrates the effect of Virgin Blue and Impulse's entry. [attached as **Appendix A**]

Substantial increases were recorded in the combined passenger activity on Australia's three busiest domestic air routes, Brisbane/Melbourne, Brisbane/Sydney and Sydney/Melbourne, increasing 41.6 per cent in comparison to January 2000.

In the above three routes and on the Brisbane/Adelaide route (where there are three or more airline operators), total revenue passengers[4] increased 42.6 per cent compared to January 2000, and revenue passenger kilometres (revenue passenger times route kilometres) increased by 43.8 per cent. Seat capacity (called available seat kilometres) increased by 39.9 per cent over January 2000 and total revenue passenger load averaged 79.50 per cent which was up significantly over the 77.35 per cent for January 2000.

As Virgin Blue does not offer any of the 'frills' services offered by the other airlines to capture the premium price, high profit business, it is essential that all its non-essential operations are low cost to maintain Virgin Blue's competitive pricing position.

Substantial operating costs for an air passenger business are fixed. They include aircraft leasing and maintenance payments, staff costs, information and system costs. The competitive strategy for a low fare operator is to maximise the utilisation of its aircraft, thereby spreading its fixed costs over more flights, keeping non-essential fixed costs low and to achieve high customer demand through low fares. It is critical that variable operating costs are kept low, because it is the difference in passenger fares and variable operating costs which determines whether the airline will be able to cover its fixed costs and be a competitive success.

Airport charges constitute a significant component of the variable costs per passenger and are therefore critical to the success of a low fare operator. They are likely to be significantly less important to a traditional high cost airline.[5]

Airport charges that Virgin Blue has to meet include:

- landing fees for the use of runways, taxiways and aprons;
- terminal passenger processing fees;

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4 Revenue Passengers are all passengers paying any fare, including frequent flyer redemption travellers.

5 A point acknowledged by APAC, at p 12 of its submission.

- passenger screening;
- check-in fees, for the use of check-in counters;
- fees for the use of sites and buildings for aircraft maintenance and storage of freight and ground support equipment;
- fees for signage;
- office rental;
- staff car parking rental;
- on-airport licence charges for vehicles; and
- identity badges for staff members.

As Virgin Blue's travel product is differentiated from its competitors, Virgin Blue has sought to obtain infrastructure consistent with that product. It is not consistent with its operating strategy for it to purchase premium terminal facilities. Where there are existing terminal facilities, it will usually be less costly to use that facility, regardless of the standard of the terminal, than to construct new facilities. However, at the time of Virgin Blue's entry at some airports, space was held only by Qantas and Ansett, with none available for new entrants on a long term basis.

Where new facilities are required, in Virgin Blue's experience, some airport operators are not willing to be flexible about the standard of terminal facility which Virgin Blue is able to access. Some airports only want to offer a standardised 'one-size-fits-all' service. This occurred at Adelaide and Melbourne Airports where Virgin Blue has been given no option but to pay for facilities at those airports which exceeded its requirements.

For example, Virgin Blue offered to construct its own facility at Melbourne Airport to ensure its needs were specifically addressed. It offered to grant access to the facility to new entrants. However, APAM refused to consider this option, electing to build the Domestic Express Terminal at substantially higher cost than that which Virgin Blue would have incurred had it constructed the facility. [**see Appendix B** Case Study – Melbourne Multi User Domestic Terminal]

3. THE CASE FOR AIRPORT REGULATION
MARKET POWER IN THE SUPPLY OF AIRPORT SERVICES

3.1 Airlines & airports - common interests but different risk profiles

Airlines and airports are, in effect, partners in providing a final air travel product to consumers. Airports and airlines are dependent on each other to meet their own commercial objectives. Airports are dependent on airlines attracting travellers to travel to and from their airport and airlines are dependent on airports providing appropriate infrastructure for the operation of commercial airline services, including runways, taxiways, aprons, terminal facilities (or land), landside roads and parking facilities (or land).

In a general sense they have a common interest. However, in fundamental respects airlines and airports operate in different commercial environments. Airlines compete directly with other airlines and as such the demand for their services is highly responsive to the price of their service.

While the overall level of demand for air travel to a particular destination is responsive to airfares, and the demand for specific airlines is highly responsive to its airfares, demand for air travel to a destination is far less responsive to the price of airport services. Consequently, the risk profile of airports (and the returns required to sustain investment) is far lower than for airlines and in particular, new entrants.

3.2 The capital city & major regional airports have market power

Airports are likely to derive substantial market power in the provision of airport services, depending on:

- the level of customer demand for travel to and from the location of the airport;
- whether or not there are sufficiently close substitutes to that airport for air travel to and from that location; and
- whether or not there are sufficiently close substitute modes of transport to air transport involving trips to and from the location of the airport. In particular, considering the relative cost of travel using alternative modes of transport.

For customers choosing to travel by air to and from each of the Australian capital cities there is no real alternative to the capital city airports (Kingsford Smith Airport (**KSA),** Melbourne Airport, Hobart Airport, Brisbane Airport, Adelaide Airport, Perth Airport and Canberra Airport).

Further, airports in regional cities and towns where there are no real alternative airports, within say 100km, tend to have substantial market power in that region (eg Rockhampton, Townsville and Cairns airport).

(a) There is well developed demand for air transport to and from each Australian capital city.

Demand for travel to a particular destination is largely inelastic. While airlines may have some capacity for conducting hub and spoke operations from different hubs, there is limited scope to do so in Australia. Further, while airlines may have some scope to transit through different airports (for example, international passengers travelling on to Perth or Hobart may be indifferent to transiting through Melbourne or Sydney) overwhelmingly, demand for travel reflects customer preferences for a particular final destination. It is this characteristic which means that inter city airport competition is, at best, marginal.

For example, the business traveller has a specific destination to go to and no other city will be sufficient (certainly within Australia where major cities are considerable distances apart). The leisure or private traveller also principally has a particular destination requirement. Where the leisure or private traveller is flexible as to their choice of final destination, that decision is highly unlikely to be affected by the cost of airport services.

The Sydney/Melbourne route is one of the five busiest city pairings in the world, and flying on this route is critically important to any new entrant airline in Australia. Approximately 6 million passengers travelled Sydney/Melbourne in previous years. The routes between Brisbane/Melbourne, Brisbane/Sydney and Sydney/Melbourne are the three most significant routes in Australia and all involve substantial total passenger numbers (see also **Attachment A**).

(b) Alternative airports are not viable departure/arrival alternatives

The secondary airports in a major city are not viable points of location for interstate commercial passenger air transport, particularly for jet engine planes equivalent or larger in size to 737's or 717's. The lack of an alternative airports within a city is due to:

- lack of currently available suitable infrastructure;
- lack of demand to sustain two such airports in most cities;
- governmental restraints on utilisation of other airport sites due to noise and community issues.

Virgin Blue initially sought access to Essendon Airport in Melbourne. However, it was unable to use this facility as Essendon Airport is unable to obtain approval for 737 aircraft. There is some

flexibility with some proportion of passengers in areas such as South East Queensland, however, recent evidence indicates that even substantial differences in airfares cause only a small percentage movement between Brisbane, Coolangatta and Maroochydore.

(c) Other forms of transport are not viable alternatives

Other forms of passenger transport such as car, bus and train are not substitutable for air travel in the vast majority of cases. The significant reason for this is that the time to travel between the major airline destinations is significantly longer by car, bus or train than by aircraft (12 hours compared to an hour and half for example). For business travellers, the additional time will outweigh any savings in cost. For leisure travellers, the current low fares compare favourably with other forms of transport, and any overnight stays relating to the time taken by other forms of transport contribute to the total cost of the holiday. Accordingly, other forms of passenger transport are not readily substitutable for aircraft travel.

The means of freight transport is determined by the required delivery time and characteristics of the freight item. Air transport is higher cost than other forms of transport, reflecting its short delivery time. Highly time sensitive freight is typically only suitable for air transport.

3.3 The case for regulation of airports

The capital city and major regional airports are key national infrastructure assets which are essential for the provision of commercial passenger air services in Australia. They have substantial market power and in the absence of any regulatory constraint would be able to exercise that market power through higher prices, inferior quality or denial of access rights for businesses which are commercially dependent on the airport.

In this way, airports are little different from electricity and gas transmission networks and certain telecommunications infrastructure. In Australia, these facilities are all subject to some form of pricing and access regulation, in addition to the behavioural restraints in Part IV of the Trade Practices Act.

The case made against the regulation of airport pricing rests on the following points:

(a) The demand for travel is largely unaffected by the cost of airport services and hence there is no negative welfare effect from higher airport prices

In short, the theory is that if demand is inelastic (that is, inelastic in response to airport charges), then, by definition, there will be little impact on overall demand through charging monopoly prices. If consumers continue to travel, just at a higher cost, then there is no loss in allocative efficiency.

This argument reflects the fact that airports do have market power (ie they can raise prices with little direct impact on demand).[6] However, this argument ignores:

- the very real impact that opportunistic pricing behaviour can have on incentives for new entry;
- the significance of airport charges for new entrants;
- the fact that new entrants bear risks which are greater than airports; and
- the fact that new entry risks are taken in order to make profits, and if profits generated by the operations of new entrants are opportunistically captured by airports, this will stifle entry, expansion and competitive activity.

Finally, distributional effects are in any event important, particularly where they will flow through to end users through the competitive activity of new entrants.

(b) Airports and airlines have a common interest such that airports will seek to facilitate airport operations and maximise airline traffic

This is the reverse of the argument advanced in (a). It says that because the airports wish to maximise their profits, they will want to maximise passenger turnover. The further point is that because airlines receive the benefit of complementary revenues, eg from car parking, they have a further incentive to reduce aeronautical charges, and to increase passenger volumes. However, this argument is in fact inconsistent with the position outlined at (a). In general, this approach is almost to explain away the need for any form of monopoly regulation.

The mere fact that airports may benefit from increased traffic does not mean that they have no incentive to maximise profits at the expense of greater passenger numbers or competitive airline activity. Any firm with market power will seek to maximise profits and, at the very least, will do so to some extent at the expense of airlines and passengers. Examples of airport market power are discussed below.

Further, there is substantial scope for airports to be opportunistic. One airport may seek to sponsor new entry, but having done so, other airports may seek to exploit that through increased charges.

(c) Airlines have substantial countervailing market power

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6 Professor Forsyth makes this point in his submission to the Inquiry.

The argument that airlines have countervailing market power in relation to the use of airport services fundamentally misconceives the concept of countervailing market power.

The ACCC, in its Merger Guidelines[7], notes that countervailing power exists where a supplier (or buyer) faces a buyer (or supplier) with market power or a credible threat of vertical integration (or other form of bypass) or direct importing. In such cases, the ability of the merged firm to increase (decrease) prices may be constrained and the likelihood of a substantial lessening of competition diminished.

The ACCC notes that countervailing power is not synonymous with small numbers of buyers (suppliers). While market concentration is necessary, it is not a sufficient condition for market power.

Whatever the position with larger airlines, the position of smaller new entrant airlines is that they have no countervailing market power when dealing with airport owners. Further, to the extent that larger airlines have more influence (if not market power) with respect to airports, airports and major airlines may inhibit the provision of low cost facilities to new entrants. An example of this is Qantas' refusal to agree to use the MUIT at Adelaide Airport unless Virgin Blue first agreed to use the MUIT. This refusal occurred in circumstances where:

- the space made available to Virgin Blue is inferior to that made available to Qantas;
- the facilities are not appropriate for Virgin Blue's strategy as a low fare operator;
- the terminal fee proposed is $4.30 for domestic passengers ($1.05 for regional passengers) upon its introduction which is substantially above the fee payable by Virgin Blue at other airports; and
- other lower cost facilities are available.

A new entrant airline on the other hand is unlikely to have any degree of market power. A new entrant airline must compete against existing operators which have substantial sunk investments in aircraft leases, information and systems, facilities (such as terminals), marketing and customer loyalty schemes and landing and take-off rights (slots).

Further, it is noted that because Qantas and Ansett lease terminals on a long-term basis, there is little opportunity for airports to exercise market power over such operators with respect to terminal facilities or land for the provision of such facilities. Accordingly, when airports seek to

[7] Paragraph 5.129 to 5.130

expand their non-aeronautical revenues (or aeronautical revenues that are not subject to the price cap), it is largely at the expense of the new entrants.

3.4 Analysis

As noted above, the argument has been advanced that while airports have market power, that any market power will not have any significant community welfare consequences either:

- because that has an insignificant impact on final consumer air prices; or
- because airports have an interest in maximising throughput through their airports.

Aside from the fact that these two contentions are inconsistent, the argument ignores the substantial impact that airport market power can have on new entrant operators and the incentives for investment for new entrants. In particular:

(a) airport charges constitute a substantial proportion of the variable costs of operation and accordingly directly impact on the level of returns achievable by new entrants. It is these returns, or the prospect of these returns, which provide the incentives for new entrant airlines to undertake risky investment;

(b) to consider the question of "allocation" of profits to be a mere distributional effect is to ignore the different risk profile of airports and airlines, particularly new entrant or low fare airlines. Airports are relatively low risk operations, with a substantial body of captured demand. Low fare airlines are high risk operations, with a high degree of firm specific demand elasticity. Therefore, the opportunity to obtain additional profits will have a much greater impact on investment decisions for low fare airlines than it will have on investment for airports. In short, the cost of capital is lower for airports than low fare airlines and therefore the regulatory framework should be keenly focused on ensuring that new entrant low fare airlines are not subject to monopoly pricing by airports;

(c) the corollary to (b) is that the suggestion that price regulation is simply a question of distribution of profits ignores the fact that the profits, if any, are derived as a result of disproportionate risk taking on the part of new entrant low fare airlines;

(d) low fare airlines face much higher demand elasticity than large airlines and are much more subject to income variability than large airlines. Therefore a regulatory framework (or the lack of one) which permits monopoly returns to airlines will disproportionately affect low fare airlines. It is suggested that if this is so, then airports will have an incentive to offer lower prices to new entrant low fare airlines. While airports will have an incentive to provide facilities for new entrants, such as terminals (largely driven by the

fact of significant complementary aeronautical and non-aeronautical revenues), they may have no interest in charging less than a monopoly price for that service (discussed below). This inevitably increases the risk for and reduces the return to the low fare airlines;

(e) the fact that necessary new investment can be treated outside of the price cap increases (not decreases) the incentive for airports to load charges onto new entrant low fare airlines. If prices were all subject to an appropriately set price or revenue cap, then to the extent that the airports' arguments that they want to foster new entrants are correct, they could undertake efficient pricing to facilitate that. In practice, there is little evidence of efficient pricing for new entrants. Rather certain airports have opportunistically sought to increase returns by a disproportionate impact on new entrants. Further, there is direct evidence that under existing arrangements airports and incumbent airlines have acted in a way to ensure that new entrant airlines were not able to obtain access to appropriate facilities at efficient prices;[8]

(f) low fare new entrant airlines are much more exposed to the monopoly power of airports because:

- they are unable to build, own and operate their own terminals and hence must pay terminal related fees to the airports, including passenger throughput fees, baggage handling fees, check-in fees, office space, signage charges, and charges for storage of airside equipment;

- they are unable to derive the benefit of complementary revenues open to incumbent airlines, including terminal concessions and valet parking fees.

(g) The argument that airports have not or will not exercise their market power is controverted by experience. In particular:

- APAM sought to impose a $2.20 charge for use of the Melbourne Domestic Express Terminal. At $2.20 and including the landing fee revenue growth which the new entrants had created,[9] APAM would have recovered the cost of the terminal in the first 21 months. The ACCC in its only detailed analysis indicated that the fee should be $1.28. Should growth meet Virgin Blue's expectations (and it may well exceed that), Virgin Blue estimates that APAM's post-tax nominal return on equity (including the landing fee increases) will be in the region of 125%. (See **Appendix B**, Case Study – Melbourne Multi User Domestic Terminal);

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8 see the Adelaide Airport example in relation to its proposed Multi User International Airport - referred to in the submission of APAC at p 13, *'Why don't airports price discriminate?'*.

9 Calculated using a 2% growth estimate per annum.

- APAM's charges for visitor car park rental, staff car park rental, office space rental, and signage are substantially above commercial market rates;

- Adelaide Airport seeks a charge of $4.30 per passenger for use of the MUIT, where Virgin Blue could be appropriately accommodated in facilities which could cost no more than 50 cents per passenger.

4. EXPERIENCE WITH REGULATION OF AUSTRALIAN AIRPORTS

4.1 Overview

The key operative elements of the regulatory framework are:

- prices surveillance of "aeronautical" services at Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville,[10] Brisbane, Melbourne, Perth,[11] and Sydney Airports;[12]

- prices of aeronautical services are subject to a CPI-X price cap at Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville Airports;[13]

- prices monitoring of "aeronautical related" services at those airports;

- quality of service monitoring;[14]

- access rights in respect of airport services at the core regulated airports (Sydney (Kingsford-Smith) Airport; Sydney West Airport; Melbourne (Tullamarine) Airport; Brisbane Airport; Perth Airport; Adelaide Airport; Coolangatta Airport; Hobart Airport; Launceston Airport; Alice Springs Airport; Canberra Airport; Darwin Airport; and Townsville Airport);[15].

In addition, there are demand management arrangements for landing and take off rights at KSA.[16]

All of the above regulatory arrangements are relevant to the prices of airport services. In this submission, Virgin Blue has focussed on the need for price regulation of airports and the appropriate form of any prices regulation, in line with the *Terms of Reference.*

4.2 Suitability of the PSA for Airport Price Regulation

Virgin Blue's experience with the price cap regime is that it has a high degree of uncertainty. The current framework, is unclear and rests more on regulatory practice than clearly defined

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10 Declaration Nos 84 (revoked) and 88.
11 Declaration Nos 83 (revoked) and 86.
12 Declaration Nos 85 (revoked) and 89.
13 Direction Nos 13 and 20.
14 Part 8 of the Airports Act.
15 s 192 of the Airports Act and Part IIIA of the Trade Practices Act.
16 Sydney Airport Demand Management Act, Regulations and the Slot Management Scheme.

regulatory rules that are typical in other regulated industries. The *Prices Surveillance Act 1983* (**PSA**) appears inadequate to properly support the price regulation of airports. The principal deficiencies are:

- the fundamental inconsistency between the CPI-X price cap, and the Price Surveillance Act which requires notification of "price increases" ;

- the inconsistency between a Ministerial Direction which is mandatory in its terms and the provisions of the Prices Surveillance Act which require only that the ACCC take account of the Ministerial Direction;

- the lack of clearly defined and enforceable processes for assessing compliance with the CPI-X price cap;

- the lack of any legislative framework for enforcement of the price cap, including the treatment of over recoveries;

- the lack of proper or suitable regulatory notification information and reporting regimes.

Virgin Blue agrees with the Draft Recommendations of the Productivity Commission in relation to the Prices Surveillance Act 1983, that price control, (where required) should be established through separate and industry specific legislation.

4.3 Price Surveillance: The Declared Services

There has been substantial debate as to the extent to which prices for commercial activities of airports should be regulated, for example, concessions, advertising and public parking fees. However, there are substantial shortcomings with the scope of price regulation with respect to those services which are undeniably aeronautical in nature (eg services provided by the airport to maintain the aeronautical operations of the airlines).

The services that are declared for the purposes of the Prices Surveillance Act, and therefore subject to prices surveillance under s 22 of the Act (as opposed to prices monitoring) are "the provision of aeronautical services, limited to":

- **aircraft movement facilities and activities,** defined to mean any of the following:

  (i) grounds, runways, taxiways, aprons;

  (ii) airfield lighting, airside roads, airside lighting;

(iii) airside safety;

(iv) nose-in guidance;

(v) aircraft parking; and

(vi) visual navigation aids.

- **passenger processing facilities and activities,** defined to mean any of the following:

(i) forward airline support area services;

(ii) aerobridges, airside buses;

(iii) departure lounges and holding lounges (but excluding commercially important persons lounges);

(iv) immigration and customs service areas;

(v) public address systems, closed circuit surveillance systems, security systems;

(vi) baggage make-up, baggage handling, baggage reclaim;

(vii) public areas in terminals, public amenities, public lifts, escalators and moving walkways;

(viii) flight information display systems; and

(ix) landside roads, landside lighting, and covered walkways.

While stated to be "aeronautical services", the list of declared services expressly excludes the provision of:

(i) aircraft refuelling;

(ii) aircraft maintenance sites and buildings;

(iii) freight equipment storage sites;

(iv) freight facility sites and buildings;

(v) ground support equipment sites;

(vi) check-in counters and related facilities; and

(vii) public and staff car parks.

The listing of the defined services is done in such a way as to lead to substantial confusion and argument as to the scope of the declared services. This has lead to revisions of the description of the declared services within the period of the price cap (eg. when aircraft refuelling was removed although now subject to a ACCC recommendation for its re-inclusion) and litigation (with the recent decision in relation to landside road charges at Canberra airport.)

The declared aeronautical services while including many of the services that support aeronautical operations at the airport, do not include all relevant services. In fact, the list of exclusions, with the exception of public car parks, exclude services which are demonstrably and inextricably connected to the aeronautical operations of airlines. This creates anomalies. For example, the exclusion of check-in counters and related facilities means that charges for such services are not included in the price cap, whereas charges for the provision of departure lounges, public areas and public announcement systems are. This has lead to somewhat artificial cost allocation arrangements in relation to new investment proposals.

Another example is signage for check-in counters. Virgin Blue has been required to pay separate fees to obtain rights to place signage above its check-in counters at Melbourne Domestic Express Terminal in addition to terminal fees. This additional charge is not subject to the price cap.

The list of declared services does not reflect a coherent list of services in respect of which there is no competitive discipline on airports.[17] Virgin Blue understands that the services which are declared are simply a list of those services for which provision was made under the Federal Airports Act for the Federal Airports Authority to charge a fee.

4.4 CPI-X Price Cap

The CPI-X price cap is set out in Ministerial Direction No 13. It applies to Adelaide, Alice Springs, Brisbane, Canberra, Coolangatta, Darwin, Hobart, Launceston, Melbourne, Perth and Townsville Airports.

In principle, Virgin Blue considers that a CPI-X price cap is an appropriate form of regulation for an airport. A CPI-X price cap which has been set with regard to appropriately determined

[17] The criteria for declaration as outlined in the Second Reading Speech to the Price Surveillance Act, cited on p 7 of the *Issues Paper*.

forward looking forecast of expenditure (including anticipated capital expenditure) and revenue (based on appropriately determined passenger forecasts) should provide adequate protection to airlines and strong incentives for airports to increase throughput and undertake efficient capital expenditure.

In practice, the CPI-X price cap as it applies has had substantial deficiencies. Aside from deficiencies as to the legal framework and the scope of the services covered by the price cap (discussed above), the principal deficiencies relate to the necessary new investment provisions.

The pass through provision for necessary new investments has a number of major deficiencies:

(a) it provides incentives for airports to define capital expenditure as a necessary new investment so that it can be charged for outside of the price cap;

(b) it provides incentives to airports to defer capital expenditure on the basis that it would not be undertaken if it falls under the price cap, ie it creates incentives to claim that investment will not occur under the price cap; and

(c) it results in protracted, repeated and overly detailed regulatory consideration of specific new investment decisions.

Each one of these outcomes is inconsistent with the objectives of incentive CPI-X regulation. Further, the experience in the airports industry is in marked contrast with other industries subject to CPI-X price caps in which incentives remain to undertake new capital expenditure within the price cap framework due to:

- the opportunities for increased efficiencies and expanded output (which produce cost savings which are kept by the airport within the regulatory period of the CPI-X price cap);

- explicit and binding service and quality of service commitments, for example, where quality of service is reflected in the price cap through penalty provisions.

The principal consideration for necessary new investment should be whether efficient investment will be undertaken under the existing price cap either by the airport or, where the airport does not wish to do so, by another investor (for example, an airline in the case of terminal facilities). There is no proper basis for permitting pass through of necessary new investment charges where the investment would be otherwise undertaken without such pass through.

Critically, the consideration of whether the investment will be undertaken should consider all incremental returns to the airport for undertaking the investment, including, as a minimum, all

incremental aeronautical revenues but also non-aeronautical revenues. This is economically efficient, as it is only in circumstances that capital expenditure would not otherwise be undertaken that it should be permitted outside of the price cap. This is of course not the same as single till regulation, as the CPI-X price cap would remain only on aeronautical prices (comprehensively and appropriately defined).

By way of illustration, it is clear that it was not necessary for the Melbourne Domestic Express Terminal to be approved as a necessary new investment outside of the price cap as it would have been built in any event, either because it would have been constructed by Virgin Blue (which offered to do so) or because the incremental returns to Melbourne from its construction massively outweighed its cost of construction. In short, its treatment outside of the price cap was not necessary.

Once an investment has been determined to be a necessary new investment for which pass through is appropriate, it should subsequently come within the price cap. Otherwise, a plethora of charges will exist which are not within the price cap and will create substantial confusion and regulatory cost. Further, if it does not become part of the new price cap it will encourage a form of cost plus regulation (which would be avoided if the pricing is subsequently included in the price cap once the investment is undertaken) where an airport which is unable to fully recoup the cost of the investment will approach the regulator to seek a price increase. This risk will be asymmetric in favour of the airports as the airlines and other operators are unlikely to have any success with the regulator in seeking to claw back excessive returns. In short, it will tend towards underwriting the airports investments.

In addition, the current necessary new investment provisions are subject to substantial error with respect to forecasting and projections. In the absence of the ability to revisit pricing approvals, it is likely that airports will gain substantial windfall profits in light of inherently conservative forecasts and projections.

Importantly, service requirements and quality of service standards should be an essential component of any price cap framework.

The Airport Service Access Regime

Currently, the regulatory framework applying to airports provides for a right of access in relation to significant airport services (s 192 of the Airports Act.). The access rights are those set out in Part IIIA of the Trade Practices Act 1974. This is a negotiate/arbitrate model. The arbitration framework in Part IIIA should be no more than a residual regulatory regime, and is not a substitute for overall price regulation. To rely on the arbitration provisions in Part IIIA alone, would result in substantial increase in regulatory costs, due to the expense of the process, delay and uncertainty. It is also likely to significantly increase the prospect for disputation. Arbitration

is an ad hoc, cost-based, solution to a particular dispute and provides a poor framework for general price regulation of a natural monopoly facility. An appropriately framed CPI-X cap would provide greater incentives to efficient airport operation, efficient pricing and efficient resolution of pricing disputes.

However, the uncertainty and limited coverage of the existing price regulation framework has placed increased focus on the utilisation of Part IIIA rights in relation to airport pricing issues[18].

Where an airport faces congestion issues, Direction 20 issued under the Prices Surveillance Act allows congestion charges employed as part of an airport demand management scheme under the *Airports Act 1996* to be passed through the price cap. Accordingly, the current structure of regulation does not prevent congestion abatement mechanisms being used.

[18] See for example, the Melbourne landside road and Melbourne Domestic Express Terminal matters in which relevant services have been sought to be designated as airport services for the purposes of s 192.

5. RECOMMENDATIONS FOR FUTURE REGULATION

Virgin Blue submits that the future regulatory framework should satisfy the following:

(a) there should be a robust legislative framework for the determination of an overall CPI-X price cap for airports. This should provide appropriate powers for the regulator to undertake a proper periodic review as in other regulated industries. As a minimum, the CPI-X price cap should apply to airports in capital cities as well as regional airports without an alternative airport within 100km.

(b) reliance on Part IIIA should be a default. It should not be the mechanism for control of airport prices.

(c) the CPI-X price cap should be applied to all aeronautical services, that is services connected with the use of the airport for the purpose of providing commercial aviation services ("aeronautical services"). The coverage of the CPI-X price cap should be by way of a general statement and the inclusion of a specific list of services, defined more comprehensively than is currently the case.

(d) the CPI-X price cap should have regard to anticipated future investment. There should be a limited test for pass through of necessary new investment outside of the price cap eg pass through should only be allowed in circumstances where it can be shown that the investment would not be undertaken (either by the airport or another party) within the price cap, and regard should be had to the views of users.

(e) there should be a specific prohibition against conduct of other airlines and other parties which would impede access or the terms of access to the airport (as with Part IIIA and the National Gas Code).

(f) an appropriate legal framework to support the regulatory regime should be established.

6. ANNEXURES

A Commonwealth Department of Transport and Regional Services *Domestic Airline Monthly Report*

B Case Study – Melbourne Multi User Domestic Terminal

APPENDIX B

CASE STUDY – MELBOURNE MULTI USER DOMESTIC TERMINAL (DOMESTIC EXPRESS TERMINAL)

1. Background to MUDT development

In late 1999, as part of its planning for entry into the Australian market, Virgin Blue commenced discussions with APAM in relation to access to domestic passenger terminal facilities at Melbourne Airport.

Virgin Blue advised that it wanted to obtain access, on a long term basis, to terminal facilities which were sufficient to handle its expected passenger numbers in a comfortable and efficient manner. In Virgin Blue's view, such facilities would contain a basic passenger arrival and departure lounge, check-in facilities and basic access to refreshments.

Virgin Blue discussed the alternatives with APAM and it was agreed that the existing facilities would not be adequate (the existing facilities were the domestic terminals owned by Ansett and Qantas and the international terminal)[19]. Site location was discussed as was the design and operation of the terminal. APAM proposed a terminal in which passengers were bussed to planes. Virgin Blue proposed a terminal in which there was a covered walkway from the check-in facilities out onto the apron so that passengers could embark and disembark by way of a short walk. (This was the solution ultimately adopted).

Initially Virgin Blue proposed to build the terminal itself at Melbourne Airport at a cost of about $5 million. The terminal proposed was sufficient to meet the needs of Virgin Blue and Impulse at a low cost. Virgin Blue proposed to guarantee access to the facility for Impulse and other low cost airlines.

However, APAM rejected Virgin Blue's proposal to build a terminal and decided to build its own multi user domestic terminal (**MUDT**) (now known as the Domestic Express Terminal).

On 30 November 1999, APAM issued a media release stating that it was investigating building a new common user terminal to accommodate domestic airlines including Virgin Blue. On 3 February 2000, APAM issued a media release stating that airlines using the terminal will pay approximately $1 per passenger.

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[19] APAM in its submission has indicated that the new entrants could have in fact been accommodated in the existing terminal space. This is inconsistent with its Submission to the ACCC for its necessary new investment proposal for the MUDT.

On 1 May 2000 APAM wrote to Virgin Blue stating that the submission to the ACCC would be around $2.00 - $2.50 per arriving and departing passenger. Such a charge per passenger represented a significantly higher charge than:

- originally announced in APAM's press release, when Virgin was finalising its business review for entry into the Australian market;
- would have been required under the cost and forecast projections underpinning Virgin Blue's proposed construction of an express terminal;
- Virgin is paying elsewhere in Australia and was then negotiating with other airports; and
- international comparisons for express terminals.

A $2.00 per passenger charge would require a higher yield for Virgin Blue to break even for each flight. It is relevant to note that the airport fees represent more than 10% of Virgin Blue's variable costs for a flight and therefore can substantially affect the profitability of flying to or from Melbourne. The facility proposed was to cost $8.5 million.

On 5 April 2000, APAM lodged formal documentation with the Minister for Transport and Regional Services for development of the MUDT and the Minister approved the Major Development Plan on 14 April 2000.

The terminal was subsequently completed and commenced operation on 4 December 2000. Prior to the completion of the MUDT, Impulse and Virgin commenced their operations out of the international terminal at Melbourne Airport. This was not a suitable long term arrangement for the continued operation of a domestic airline.

2. Application by APAM for cost pass through of MUDT through the price cap

On 24 May 2000, APAM notified the ACCC of a proposal to introduce an aeronautical charge of $2.20 (GST inclusive) per passenger, to recover the cost of the new MUDT at Melbourne Airport. The application was internally inconsistent as to whether the price was to be levied only for each departing passenger (which would have conformed with APAM's initial publicly announced proposal) or for each passenger (departing and arriving). Subsequently APAM clarified that the charge was to be levied on each passenger.

APAM stated in its notification that it had negotiated a commercial agreement with Impulse for a price less than the notified price. The price at which APAM had negotiated with Impulse was $1.65 per arriving and departing passenger (inclusive of GST).

APAM justified the fee based on the cost of constructing the terminal and its estimate of forecast passenger numbers. APAM did not account for incremental revenues received by way of increased complementary landing and other aeronautical charges and other non-aeronautical charges, such as car parking. In addition, APAM could expect additional aeronautical and non-aeronautical revenues due to the overall expansion of travel at the airport (ie, there would be an increase in Qantas and Ansett passenger numbers as competition expanded the market). APAM took the position that it was exposed to substantial risk in constructing the terminal.

Virgin Blue was concerned at the high level of the passenger fee. Virgin Blue considered the forecast projections were unduly pessimistic and, further, that the construction of the terminal would have been justified on the basis of its impact on overall air passenger numbers at Melbourne Airport at a significantly lower passenger fee.

In order to address its concern at the level of the passenger fee and the contention that APAM was exposed to substantial risk, Virgin Blue offered two commercial solutions:

- purchase the MUDT or construct a suitable common user facility (a solution proposed by Virgin Blue on various occasions); or

- adjust passenger processing fees based on actual throughput (such that Virgin Blue bore the risk of low passenger numbers).

However, these offers were rejected by APAM. Accordingly, Virgin Blue lodged a submission to the ACCC in relation to APAM's pricing proposal for the MUDT[20].

The principal aspects of Virgin Blue's submission where that:

- the approach to passenger forecasts was unduly pessimistic, inflating the required passenger processing fee. The passenger throughput levels which underpinned APAM's proposal were substantially below those projected by the Virgin Blue and Impulse. The application in effect ignored the projections made by Virgin Blue;

- complementary incremental aeronautical revenues (principally landing fees) that would have been derived from the terminal's construction justified its construction at a significantly lower passenger processing fee. Virgin Blue noted other complementary incremental revenues from non-aeronautical services, but in its formal modelling did not actually take these into account.

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20 (Virgin Blue expressly offered to make the submission available to the ACCC on a non-confidential basis so that it could be released for public scrutiny. However, the ACCC did not request this. Instead the ACCC requested permission to quote from the submission in its draft decision, which Virgin consented to.)

APAM has derived substantial incremental revenue from the construction of the MUDT which would have commercially justified it being built even without any passenger processing fee. By way of illustration, the incremental landing fees which APAM has derived as a result of the new entrants and the construction of the MUDT, are likely to be in the order of:

- $2.4 million taking into account Impulse and Virgin Blue flights alone; and

- approximately another $1 million taking into account the increase in Qantas and Ansett flights as well.

Based on figures from Department of Transport and Regional Services the increase in landings and take-offs from Melbourne as at January 2001 are:

Months	**Melbourne/Sydney**	**Melbourne/Brisbane**
Jan 2000	2,831	1,392
Jan 2001	3,752	1,841
Increased Landings/Take-offs	921	449

For the Melbourne/Brisbane route, the amount of revenue from landing fees is calculated on Virgin Blue's aircraft weight (Impulse does not compete on this route). Accordingly, as half the above figures are take offs (and not landings where the fees are levied), by dividing 449 by 2, then multiplying by Virgin Blue's landing weight of 65 tonnes at $5.2727 per tonne, the increase in landings has resulted in $76,943 a month increase in landing fee revenue for APAM.

For the Melbourne/Sydney route, dividing 921 by 2, then multiplying by Impulse's landing weight of 52 tonnes at $5.2727 per tonne, the increase in landings has resulted in $126,260 a month increase in landing fee revenue for APAM. (Virgin Blue does not compete with Impulse on this route)

Combined, based on January being an indicative month, the increase in APAM's revenue from landing fees alone is $2,438,436. Even more revenue from landing fees will be derived when additional services from Melbourne come on line. Virgin Blue is proposing to commence 3 return Melbourne/Adelaide flights in May 2001, which will contribute an additional $31,875 per month or $383,500 per year in landing fees. Impulse have also announced the commencement of 4 return Melbourne/Hobart flights which will contribute an additional $34,000 per month or $408,000 per year in landing fees.

Virgin Blue's principal submissions were largely reproduced in the ACCC Draft Decision.

Virgin Blue rejects any suggestion that ‘gaming’ was involved in its submission. It submitted its validly held views to the ACCC in relation to a proposal which involved a substantial charge for Virgin Blue’s operations. In relation to APAM’s view that the process involved ‘significant cost and potential termination of the project”, there was no danger to the project as Virgin Blue had offered to build the facility itself. As for the ‘significant cost’ incurred, if APAM had submitted a proposal which met Virgin Blue’s needs, at an appropriate price, as Sydney airport did, an agreement would have been reached without Virgin Blue needing to seek to argue that the price was too high. Despite the assertion in some submissions that there is no incentive to reach agreement, agreement was reached with Sydney airport.

The ACCC issued a draft decision on 27 June 2000 at a price of $1.28 per passenger (GST inclusive) for the use of the MUDT facility.

Virgin Blue understands that the ACCC received submissions relating to the draft decision from:

- Ansett Australia;
- Australia Pacific Airports Melbourne Pty Ltd (the operators of Melbourne Airport);
- Board of Representatives of Australia;
- Brisbane Airport Corporation;
- Impulse Airlines;
- Sydney Airports Corporation Limited (the operators of Sydney Kingsford Smith Airport); and
- Qantas Airways Limited.

However, these submissions (including APAM's) have not been made available to Virgin Blue. Virgin Blue did not lodge a further submission, in light of subsequent consultations with the ACCC. Subsequent to the draft decision being issued, but prior to the final decision, Virgin Blue was approached by the ACCC. The ACCC indicated to Virgin Blue that it was going to revise its decision to approve a fee of $1.65 (including GST). The ACCC offered no substantial basis for the revision to its earlier view (other than that Impulse had agreed to that figure) and no substantive analysis of how the fee of $1.65 was justified. In light of the ACCC’s foreshadowed position, Virgin Blue subsequently agreed in principle to APAM’s proposal for a fee of $1.65, with scope for:

- a reduced fee if passenger numbers exceeded substantial targets (targets which if reflected in the pricing proposal would have warranted a lower fee);

- revision of the fee if, after two years, both Virgin Blue and Impulse were still operating from Melbourne, as a substantial amount of APAM's risk would have been mitigated (APAM had originally proposed a revision after two years in its initial submission to the ACCC).

On 22 August 2000, APAM informed the ACCC that it had negotiated a price with Virgin Blue and Impulse Airlines for the use of the MUDT.

On 25 August 2000, the ACCC issued its final decision. The ACCC's final decision was that the agreed fee of $1.65 (GST inclusive) for use of the MUDT was acceptable. However, no substantive revised analysis was undertaken to substantiate that price. While the ACCC did note it had revised its view as to the appropriate asset beta and passenger throughput levels, no analysis of the impact of these changes in the final decision is apparent. Instead, the ACCC placed particular reliance on the fact that the fee had been agreed to by Virgin Blue and Impulse. It should be noted that this outcome only followed informal advice by the ACCC, prior to its final decision being announced, that it was proposing to approve this price.

The new MUDT opened on Monday, 4 December 2000.

Subsequent to the "in principle" agreement on price in August 2000, Virgin Blue and APAM were unable to agree on arrangements for the two year pricing review. Virgin Blue's advice was that there was no legal capacity for the ACCC to revisit its approved price of $1.65, notwithstanding that APAM had lodged the proposal on the basis that it would be reviewed after two years. Virgin Blue was advised that its only right to have the price reviewed was either by way of a contractual provision which explicitly acknowledged that right or by way of an access dispute under Part IIIA of the Trade Practices Act. Virgin Blue was advised that there was residual uncertainty as to its arbitration rights under Part IIIA so long as the issue of declaration of the use of the terminal as a declared airport service was unresolved.

APAM has been unwilling to agree to a commercial review of the fee and, accordingly, Virgin Blue has sought to protect its position by way of an application for the designation of the use of the MUDT as an airport service under s 192 of the Airports Act, for the purposes of Part IIIA of the Trade Practices Act.

APAM has asserted that Virgin Blue seeks to use the ACCC as a 'commercial arbitration service'. APAM fails to acknowledge that as distinct from normal commercial relationships, Virgin Blue is forced to deal with APAM as a monopolist provider, and the only recourse that

Virgin Blue has in relation to APAM's unilateral decisions is to the ACCC. That Virgin Blue has access to the ACCC is crucial in light of APAM's pricing proposal for the MUDT.

Maintain ACCC involvement is particularly important in light of the fact that on two occasions APAM gave notice to Virgin Blue that Virgin Blue could not continue to operate from Melbourne Airport in the absence of final agreement on the terms of access to the MUDT.

In particular, after being given less than one week's notice of the move to the MUDT from the International Terminal by APAM, Virgin Blue was informed by APAM that unless it signed the lease, it would have to leave the International Terminal and could not operate from the MUDT. Subsequently, APAM said this was a 'misunderstanding' and Virgin Blue could remain at the International Terminal in the absence of an agreement about the MUDT, however, the fixed passenger screening equipment would be removed causing substantial delays to Virgin Blue's flights.

Ultimately, an interim arrangement was reached between APAM and Virgin Blue to access the MUDT, but not before Virgin Blue had to consider taking action against APAM to remain in the terminal and continue its operations.