NON-CONFIDENTIAL VERSION

PRICE REGULATION OF AIRPORT SERVICES

SUPPLEMENTARY SUBMISSION TO THE

PRODUCTIVITY COMMISSION

FROM VIRGIN BLUE AIRLINES

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1. INTRODUCTION

Virgin Blue Airlines Pty Limited (**Virgin Blue**) is pleased to make this supplementary submission to the Productivity Commission (**Commission**) in response to the Commission's inquiry into the price regulation of airport services (**Inquiry**).

This supplementary submission responds to a number of important issues raised in other submissions lodged with the Commission in relation to the Inquiry. In this supplementary submission, Virgin Blue has not sought to respond to each and every point raised by other parties but instead is confining its comments to important issues of fact and analysis where Virgin Blue considers that its response would benefit the Commission in preparing its draft report.

2. PROPOSED DISPUTE RESOLUTION PROCEDURES

2.1 Support for Independent Arbitration

Virgin Blue notes that a large number of parties agree that a system of independent dispute resolution is required in order to ensure efficient commercial negotiations between airlines and airports. Parties suggesting independent dispute resolution (generally arbitration) include:[1]

- the Department of Transport and Regional Services (**DOTARS**);
- Melbourne Airport;
- Qantas;
- Rex; and
- Virgin Blue.

Virgin Blue recommended an independent dispute resolution model where if an airline and a major airport could not agree on the terms and conditions on which the airport would supply (appropriately defined) aeronautical services, then either party would be able to refer the matter to the Australian Competition and Consumer Commission (**ACCC**) for arbitration under the procedure set out in Part IIIA of the *Trade Practices Act 1974* (**TPA**).

[1] The submission from the Australian Council for Infrastructure Development (**AusCID**) urges the Commission to give careful consideration to certain proposals (of which it was apparently aware) that will be put to the Commission in relation to dispute resolution. It is not clear which submissions AusCID is referring to in its submission, and therefore Virgin Blue has not assumed that the relevant proposals are those that call for independent arbitration.

2.2 Who Should be the Arbitrator?

Certain parties (including DOTARS and Melbourne Airport) have suggested that the parties be able to agree on a commercial arbitrator to resolve a dispute rather than being required to proceed to arbitration before the ACCC as suggested in the recommended model in Virgin Blue's submission.

Virgin Blue sees merit in allowing parties to agree, on a dispute by dispute basis, to have the dispute resolved by a commercial arbitrator rather than by the ACCC. However, if the parties could not agree on a commercial arbitrator, then there would need to be a default or fall back position for independent arbitration, and Virgin Blue considers that arbitration by the ACCC under Division 3 of Part IIIA of the TPA is the only realistic default position. It is especially important to have a neutral arbitrator such as the ACCC in circumstances where there may be a limited pool of commercial arbitrators who:

(a) have the necessary expertise and knowledge to arbitrate disputes over the supply of aeronautical services (which could require the analysis of complex pricing models); and

(b) have not performed significant work for either an airline or an airport (which may give rise to perceptions of potential bias).

Some airports have expressed a preference not to have the ACCC arbitrate disputes between airports and airlines. Virgin Blue believes that this preference is driven solely by a concern that, on the basis of past regulatory decisions, the ACCC may not allow airports to retain excess profits. This concern is expressed in different ways, for example Adelaide Airport states that:

> "*Perceptions that regulatory decisions tend to be biased in favour of airport users tends [sic] to create an artificial constraint on commercial negotiations.*" (5th para under section 2)

Two points need to be made in response to this statement. First, outside of the narrow confines of airport operators, Virgin Blue is not aware of any perception that the ACCC's decisions were biased in favour of airport users. Further, complaints from regulated entities that regulators set prices too low are to be expected. Secondly, whatever constraint that regulatory decisions have had on commercial negotiations, it has evidently been insufficient to constrain airports from deriving aeronautical revenues far in excess of aeronautical costs. The extent of airport overcharging is discussed at length in the Report from the Allen Consulting Group attached to Virgin Blue's initial submission to the Commission.

In its submission, Melbourne Airport notes that in its price monitoring role, the ACCC has largely limited itself to factual commentary on the information it is publishing. Melbourne Airport then goes on to state:

> "*However, in its press statements the ACCC has tended to focus on price increases since price notification was removed. In doing so, it rarely reflects on the level of investment that has occurred at some airports, the fact that in many cases these increases were agreed with users and that there are now contractual arrangements in place – all facts that are well known to it.*" (p 42)

Melbourne Airport is complaining that the ACCC, when asked to monitor the "prices, costs and profits" of aeronautical services, is reporting on the prices of aeronautical services and is not providing commentary on whether or not there are contractual arrangements in place between airports and airlines. A simple reason why the ACCC is not doing this is because it is outside the scope of its price monitoring task. Another reason why providing commentary on the state of contractual arrangements would be of little value is that airports often deem contracts to be agreed through performance, ie the airport notifies the airlines of the price increase and the airline accepts the offer contractually by not withdrawing all services from the airport. Further, as discussed in more detail in section 3.1 below, Melbourne Airport has an idiosyncratic view of what constitutes agreement between an airline and an airport.

Virgin Blue considers that Melbourne Airport's other criticisms of the ACCC in section 3.3 of its submission reflect a combination of:

(a) a concern the ACCC would not allow Melbourne Airport to recover excessive profits;

(b) a misunderstanding of the ACCC's price monitoring role; and

(c) a misunderstanding of the Government's Review Principles and how prices should reflect efficient costs.

None of the criticisms made of the ACCC by Melbourne Airport have any substance and for the reasons set out above (including expertise and independence) the ACCC remains the best option for a default or fallback arbitrator.

2.3 Comments on Alternative Arbitration Models

Melbourne Airport has recommended a new industry specific arbitration process for the 5 largest airports (Melbourne, Sydney, Brisbane, Perth and Adelaide). While Virgin Blue welcomes Melbourne Airport's recommendation of independent arbitration to resolve disputes, it is concerned by the unnecessary complexity of the proposed process.

Without seeking to comment in detail on Melbourne Airport's proposal, it would appear to involve a series of processes involving the Minister and then a price inquiry under Part VIIA of the *Trade Practices Act 1974* (Cth) (**TPA**) as a prelude to commercial arbitration with an unspecified arbitrator. If the airport did not consent to commercial arbitration then aeronautical services at the relevant airport would be declared.

The process proposed by Melbourne Airport looks more complex than the current process under Part IIIA where the National Competition Council (**NCC**) makes a declaration recommendation to the Minister who then decides whether or not to declare the service. If anything, Melbourne Airport's process is likely to take longer and involve more expense than the existing (protracted) declaration process.

Therefore, Virgin Blue considers that its own proposal, under which aeronautical services at the major airports are automatically declared, is a more efficient, timely and cost effective solution.

Qantas has suggested a number of different options for improving the current regime, each of which relies on a Core Principle that emphasises commercial negotiation and binding dispute resolution. Virgin Blue agrees that the Core Principle is a sound guiding principle to apply in considering improvements to the current regime. Virgin Blue considers that access undertakings, backed by deemed declaration (see section 4.4 of the Qantas submission), may offer a reasonable alternative model to Virgin Blue's preferred model.

3. NEGOTIATIONS BETWEEN VIRGIN BLUE AND AIRPORTS

Virgin Blue is concerned that the submissions from several major airports have not accurately described their negotiations with Virgin Blue over aeronautical services agreements.

Virgin Blue considers it important that the Tribunal fully understand the negotiation processes and dynamics in relation to Virgin Blue's negotiations with Melbourne Airport, Sydney Airport and Darwin Airport in relation to aeronautical services.

3.1 Melbourne Airport Negotiations

In its submission to the Commission dated July 2006, Melbourne Airport states at p 34 that the prices it introduced in July 2002 were part of an overall commercial package and that:

> "*The prices offered by Melbourne Airport were accepted by airlines without dispute or any counter offer being made.*"

Virgin Blue is surprised by this statement from Melbourne Airport. [**CONFIDENTIAL**]

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In these circumstances, Virgin Blue does not see how Melbourne Airport can assert in its submission that the prices were accepted by airlines without dispute. Indeed, later in its submission, Melbourne Airport admits that it knew that Virgin Blue objected to per passenger charging:

> "*The Commission will be well aware of Virgin Blue's general objection to passenger based charges for airside services at Sydney Airport.* ***Melbourne Airport understood these objections when it put its initial pricing offer to airlines in 2002***." (emphasis added)

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3.2 Sydney Airport Negotiations

Negotiations over the Long Term Agreement

Sydney Airport Corporations Limited (**SACL**) has been engaged in protracted and fitful negotiations with airlines for over two years in relation to a long term agreement for take off and landing charges. In its submission to the Commission, SACL refers to its negotiations with airlines and with BARA in relation to international charges in the following terms:

> "*While progress has not always been as either party might desire, there has been ongoing negotiation and compromise in which the list of outstanding issues has been consistently whittled down. While there remain some important issues yet to be resolved, there is no reason why this cannot be achieved by negotiating in good faith within the current regulatory environment.*" (p 22)

Virgin Blue considers that this summary does not accurately reflect either how the negotiations in relation to domestic charges have progressed to date, nor how they are likely to conclude within the current regulatory environment. Indeed, the Tribunal in *Re Virgin Blue Airlines* found that in the absence of any ability to have matters arbitrated independently, negotiations with SACL over

the price of aeronautical services is likely to be resolved through SACL exercising its market power to impose its will, not through "good faith" negotiations. The Tribunal stated at [332] that:

> "*What this analysis demonstrates is that there are likely to be substantial revenue issues during the period in respect of which declaration is sought, this being five years, and beyond. In the light of the history of the development of the Domestic PSC and the manner in which SACL is contemplating imposing further charges, these revenue issues are likely to be resolved by SACL exercising monopoly power to impose upon the airlines a level of revenue growth which would not be open to it in a competitive environment.*"

The pricing elements of SACL's proposal would result in significant over-recovery of SACL's costs. While the proposed take off and landing charges do not represent significant per passenger increases, given that the vast majority of SACL's costs are fixed and that passenger numbers are increasing steadily, this will result in rapidly expanding aeronautical margins for SACL. In turn, revenues in excess of costs result in reduced demand for airline services and a deadweight loss in social welfare.

SACL first raised the matter of a long term pricing proposal for domestic take off and landing charges in June 2004. In the lead up to the Tribunal hearing (which took place in October 2004) there was a short period of intense activity in which SACL provided a number of pricing models to Virgin Blue as well as a draft agreement. These proposals were then relied on by SACL in the hearing before the Tribunal as evidence of its willingness to negotiate commercially and set reasonable take off and landing charges.

However, in the period since the Tribunal hearing, SACL has had no interest in negotiating with Virgin Blue over long term pricing for domestic take off and landing charges. Virgin Blue has assumed that this lack of interest was due to the fact that the Tribunal's decision was pending, and that SACL did not want to enter into negotiations until it had seen the Tribunal's decision.

In December 2005, the Tribunal announced its decision to declare the Airside Service at Sydney Airport, finding that SACL's move from weight based charges to per passenger charges for take off and landing had been a misuse of market power.

In its submission to the Commission, SACL notes that:

> "*In addition, the prevailing nature of the regulatory environment in which these negotiations have been progressing has itself provided an inducement for airlines, quite rationally, not to conclude final agreements. This is because, in doing so, they may deprive themselves of further advantage that they perceive might otherwise arise through either the Virgin Part IIIA proceedings or this scheduled Productivity Commission review.*" (p 25)

Virgin Blue remains open to reaching a commercial agreement with SACL, and is surprised by this observation from SACL when it has been SACL who has been unwilling engage in substantive negotiations pending the outcome of first, the Tribunal's decision and secondly, the judicial review proceedings it has chosen to pursue.

Export and Infrastructure Taskforce

In its submission, SACL refers to the recommendations of the Export and Infrastructure Taskforce and states that it considers that they are relevant to an assessment of the expected price outcomes under existing regime for aeronautical services. SACL claims that airports are "at least as important a piece of international infrastructure as the ports" and that the recommendations of the Export and Infrastructure Taskforce should therefore apply to airports.

The purpose of the Taskforce was to identify "*bottlenecks of a physical or regulatory kind, in the operation of Australia's infrastructure that may impede the full realisation of Australia's export opportunities*". (Report p 1) Given the purpose of the Taskforce, it could not be seriously argued that the recommendations were intended to cover airports as they operate under the current regime (where the only bottleneck is the market power of airports). Further, charges for domestic airlines are not export related. Virgin Blue also notes that one of the three members of the

Taskforce was Mr Max Moore-Wilton, who was then CEO of SACL and is now Chairman of Macquarie Airports Management Limited.

3.3 Darwin Airport

In its submission, Northern Territory Airports (**NT Airports**) states that "*All airlines have readily accepted the transition from MTOW to PER PAX based charges.*" (p 10) Virgin Blue notes that it was not flying to Darwin Airport when this transition took place.

Further, in its submission, NT Airports refers to its Conditions of Use which it says it is continuously reviewing and updating. Virgin Blue notes that under these Conditions of Use:

(a) NT Airports may vary any Aviation Charge at any time by giving 30 days' notice in writing (clause 7.4);

(b) NT Airports may vary any other term of the Conditions of Use so long as NT Airports provides 60 days' notice and consults in good faith with airport users over the variation during the notice period (clause 2.6); and

(c) there is a dispute resolution procedure, but it only provides for disputes to be referred to Authorised Officers of the parties and then to the CEOs.

In short, the Conditions of Use allow NT Airports to increase aeronautical charges with only 30 days' notice and without consultation, and the dispute resolution process falls well short of binding arbitration.

Further, Virgin Blue notes that it has been prevented from engaging in constructive commercial negotiations with NT Airports because it has consistently refused to provide Virgin Blue with a working copy of the model it has used to justify its latest round of price increases.

4. PRICE DISCRIMINATION BY AIRPORTS – ABSENCE OF INCENTIVES FOR AIRLINES

A number of airports in their submissions talk about the price discrimination that is practiced by airports. For example, on p 1 of its submission, the Australian Airports Association states that:

> "*The current regulatory regime has also facilitated the establishment of commercial agreements between airports and airlines, more efficient risk sharing and the emergence of pricing discrimination through volume discounts and new airline incentives.*"

One of the changes that SACL notes has taken place since 2002 is:

"*expectations of airlines that they will be provided with incentives by airports for new routes and services*." (p 4)

These comments are made by airports in the context of demonstrating that they have engaged in efficient price discrimination as required by the Government's Review Principles.

However, Virgin Blue's experience as a recent entrant into the domestic aviation industry in Australia is that major airports rarely offer reduced aeronautical charges as an incentive to encourage airlines to introduce additional flights or routes at the airport.[2] Melbourne Airport expressly refers to marketing and other incentive arrangements as one way in which airports can price discriminate, and states in its submission that:

"*The last decade or so has seen the payment of rebates and marketing incentives by airports to airlines become common industry practice.*" (p 24)

However, despite this "common practice", Virgin Blue has never received any incentive payments or reductions in domestic take off and landing charges for new flights or routes to or from Melbourne Airport, despite being the notable new entrant of the last decade. Similarly, despite SACL's comments about the expectations of airlines with regard to incentives, SACL has never provided Virgin Blue with any incentives in relation to take off and landing fees.

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The only other occasion on which SACL offered Virgin Blue incentives was when Virgin Blue objected to per passenger charges for domestic take off and landing charges. In response, SACL offered to provide a rebate on charges for international services in return for Virgin Blue agreeing to domestic per passenger charging for take off and landing. However, this was not an attractive offer for Virgin Blue because the rebate was only being offered for a short period of time and per passenger charging would have a significant impact on Virgin Blue's domestic operations.

Finally, Virgin Blue notes that a number of airports have referred to airports competing to attract airlines traffic. For example, SACL refers in it submission to "*increased competition among Australian airports for new traffic and for the location of airline headquarters and maintenance operations*" (p 4). It could be expected that competition would result in airports offering airlines better terms and conditions to use their facilities. However, given Virgin Blue's experience in

[2] Virgin Blue notes that it does receive volume discounts for take off and landing fees at [**CONFIDENTIAL**] Brisbane Airports if it exceeds particular traffic levels.

relation to incentives, Virgin Blue does not consider that this alleged competition is reflected to any significant extent in the conduct of major airports in Australia.

5. PRICE DISCRIMINATION BY AIRLINES

In its submission to the Commission, Melbourne Airport states that airlines have the ability to price discriminate, specifically claiming:

> "*… it is clear that airlines can and do effectively price discriminate at the passenger level and that the airlines' ability to do so is sufficient to ameliorate the welfare impacts of a significant proportion of any increase in aeronautical charges, especially if such increases are small compared to ticket prices. Further, it is clear that whatever price discrimination airports can undertake does not materially impact economic welfare in a negative way.*" (p 19)

Although airlines do engage in price discrimination through their revenue management practices, this is not perfect price discrimination, and airlines do not capture the whole of the available consumer surplus. Rather, price discrimination is used by airlines to maximise profits given their high level of fixed costs, as acknowledged by the Commission in its previous Airport Pricing Inquiry (2002):

> "*the price discrimination undertaken by airlines may indeed be necessary to cover their fixed costs.*" (p 131)

Virgin Blue also strongly refutes Melbourne Airport's claim that price discrimination by airports results in any increase in aeronautical charges having a minimal effect on social welfare.

Melbourne Airport's argument relies on airlines being able to engage in perfect price discrimination, and airlines (not being monopolies) are only able to engage in third degree price discrimination. Secondly, Melbourne Airport's argument assumes that any increase in the cost base of an airline can be passed on to less price sensitive passengers without reducing demand. However, this argument ignores the fact that a profit maximising airline has already increased its prices for different classes of customers to the point of elasticity. Therefore, any further increase in price will have an impact on demand.

Virgin Blue refers the Commission to its initial submission, specifically *Section 3: Virgin Blue's Entry and Business Model* and *Section 4: Why Airport Charges Matter*. Broadly, these sections provide background on the sensitivity of a low cost carrier (**LCC**) business model such as Virgin Blue to its cost base, and the resultant need to minimise costs to stimulate additional demand for air travel. As a result:

> "*…any increase in aeronautical charges is likely to lead to an increase in at least some fares on routes to and from the relevant airport (or a reduction in the availability of discount fares). Given that demand for domestic air travel is relatively elastic, this will result in a drop in the number of passengers, with a consequential deadweight loss for society.*" (p 22 of Virgin Blue's initial submission)

Further, the implementation of a passenger based charging regime restricts the ability of airlines to price discriminate by converting a charge that was fixed on a per flight basis to one which is marginal and varies per passenger. This was highlighted in the Commissions' initial Airport Pricing Inquiry (2002):

> "*Passenger-based charging reduces the scope for price discrimination on some margins (for example, aircraft size), but scope for discrimination remains on others (for example, between passengers travelling on different airlines at different times of day, or between domestic and international passengers).*" (p 91)

6. PER PASSENGER VS WEIGHT BASED CHARGING

A number of airports make lengthy submissions in relation to the question of whether per passenger charging for take off and landing charges is:

(a) inefficient; or

(b) has an adverse impact on competition in the airline industry.

As noted in Virgin Blue's submission to the Commission, Virgin Blue believes that per passenger charging for take off and landing charges (but not for terminal charges) is both inefficient and has a substantial adverse impact on competition in the dependent airline industry.

Unsurprisingly, those airports that have introduced per passenger charging (or are considering introducing per passenger charging) assert that this method of charging is efficient and does not have any significant impact on competition in the dependent airline industry.[3] Virgin Blue is surprised that the airports continue to maintain this position when the issue was well ventilated before the Tribunal in *Re Virgin Blue Airlines* and the Tribunal made such unequivocal findings in relation to this issue.

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[3] BARA also supports per passenger charging in its submission to the Commission. Virgin Blue notes the following: first, BARA represents international airlines, not domestic airlines such as Virgin Blue; secondly, its members (excluding Virgin Blue in relation to its international subsidiaries) are all full service airlines and per passenger charging benefits them at the expense of low cost carriers; thirdly, Virgin Blue does not agree with this section of BARA's submission.

Before responding to some of the points raised by the airports, it is worth remembering that the only other country in the world where airports charge on a per passenger basis for takeoff and landing fees is New Zealand (and even then only at Wellington Airport).

In its submission, Melbourne Airport leads into its arguments in relation to per passenger vs weight based charges by observing that:

> "*It is not clear that if the facts in relation to another airport were competently presented to the Tribunal that it would reach the same general position on the relative merits of weight versus passenger based charges.*" (p 59)

Having said this, Melbourne Airport then proceeds to present to the Commission the same arguments that were presented to the Tribunal by SACL in *Re Virgin Blue Airlines* and rejected.

Further, it cannot be said that the presentation of the facts and the arguments to the Tribunal, nor the analysis by the Tribunal, was lacking either in terms of the factual material or the economic arguments presented. Six separate economists gave evidence to the Tribunal (of whom three dealt in detail with this issue) and the Tribunal consists not only of a Federal Court judge but also of a lay member and an economist.

6.1 Per passenger charges encourage the use of larger, more efficient aircraft and will encourage more efficient use of airports' assets

Melbourne Airport argues that per passenger charging encourages more efficient use of airports' assets (including runways, aprons and taxiways), largely because it encourages airlines to use larger aircraft than those used by Virgin Blue.

There are three fundamental problems with this argument:

(a) for the vast majority of domestic routes, aircraft larger than the aircraft operated by Virgin Blue are significantly less efficient from the perspective of airlines, passengers and airports;

(b) per passenger charging is unlikely in any event to be determinative of airlines' choice of fleet, and therefore would not result in the use of larger aircraft even if they were more efficient (which they are not); and

(c) there is currently no compelling reason for airports to want to discourage airlines from using smaller aircraft (if this was what per passenger charging is in fact intended to do) since they are not capacity constrained. Even if they were capacity constrained, the

efficient response (as set out in the Review Principles) would be to introduce peak and off-peak charging.

Virgin Blue agrees that the effect of moving from weight based charges to per passenger charges results in lower charges per flight for larger aircraft, given fixed aircraft configurations and load factors. However, the key impact of per passenger charges is that they result in higher take off and landing charges per flight for any model of aircraft the more people the aircraft carries. Therefore, if an airline configures an aircraft to carry more people, for example by eliminating business class and on board galleys, holding load factors constant that airline will pay more per flight to operate that aircraft than another airline will pay to operate exactly the same model and weight (MTOW) of aircraft with a less efficient configuration (ie with fewer seats).

Through its argument, Melbourne Airport is implying that Virgin Blue is using inefficiently small aircraft and that per passenger charging will encourage Virgin Blue to use larger, more efficient aircraft. However, an objective consideration of the evidence demonstrates that the aircraft used by Virgin Blue are efficient from the point of view of airports, airlines and passengers.

Medium Size Aircraft are Efficient for Airlines and Passengers on Domestic Short Haul Routes

Virgin Blue uses Boeing 737 aircraft. The most common aircraft type in Virgin Blue's fleet is the Boeing 737-800, which carries 180 passengers at full capacity. Virgin Blue notes that at a load factor of 80%, this would result in Virgin Blue carrying 144 passengers per 737-800 flight.

Virgin Blue would like to note that the 737-800 is not a small aircraft. In its submission to the Commission, SACL stated that it forecast average number of passengers per flight for 2005/6 for all flights (ie including international flights using Boeing 747s) would be approximately 120 (p 10). A 737-800 with 144 passengers is well above this average of all flights at Sydney Airport.

The 737-800 is an extremely efficient short haul aircraft. This can be seen from the fact that LCCs around the world rely on (often single class) fleets of Boeing 737s (ie Southwest Airlines and Ryanair) or the equivalent sized aircraft made by Airbus, the A320 (ie JetBlue Airways and EasyJet). The key reasons why it is efficient from an airline's perspective to use medium size aircraft such as these are that:

(a) in addition to being used on heavy traffic routes, they can also be used on thinner traffic routes while still maintaining an acceptable frequency of flights; and

(b) they have short turn around times (25 – 30 minutes).

The problem with using aircraft larger than the Boeing 737 or the Airbus A320 on domestic routes is that unless the route is extremely busy (such as Melbourne-Sydney at peak hour), the airline is forced to either:

(a) reduce the number of services to balance the increase in capacity brought about by using larger aircraft; or

(b) run the larger aircraft at significantly reduced load factors.

Reduced load factors can quickly result in significant losses if the load factors drop below the break even point. Reducing the number of services may be possible in some circumstances, but this in turn will have impacts on an airline's scheduling and will also impact on customers' utility because there will be fewer flights to choose from. In a competitive market an airline operating a larger aircraft less frequently would expect to lose passengers to a competitor who offered more frequent, convenient flights. Route frequency is a key driver of many types of passengers, especially those travelling on business. Further, reducing the frequency of flights would result in significant scheduling inefficiencies.

The second important advantage of a B737 or an A320 compared with larger aircraft is the shorter turn around times. The time taken for Virgin Blue to turn around a B737 at the majority of airports is only 30 minutes. Larger aircraft take significantly longer to turn around, which means that they take up space on the apron for longer and therefore they are not able to complete as many flights per day as smaller aircraft.

This is why aircraft such as the B737 are often preferred by airlines (including FSAs such as Qantas) for short haul domestic routes. Virgin Blue estimates the practical turn around times for different Boeing aircraft as follows:

Aircraft	**Capacity**	**Turn around time**
Boeing 737-800	180	30 minutes
Boeing 767	245-375	75-90 minutes
Boeing 747	426-524	120 minutes

On the basis of Melbourne Airport's arguments, Virgin Blue should be using Boeing 747s for domestic routes as this would be more efficient. However this would be patently inefficient. A Boeing 747 would fly from Melbourne to Sydney (flight time of just over an hour) and then require two hours on the ground before making the hour journey back to Sydney where it would sit on the ground again for two hours. Such large aircraft carry fewer (not more) passengers over

the course of a day on routes under two hours' duration. Virgin Blue carries a significant number of its passengers on flights of under two hours' duration.

While it might seem an obvious point, aircraft only earn revenue when they are flying, and airlines aim to maximise aircraft utilisation (ie flying time) in order to maximise profits. If very large aircraft were used for all short haul routes then aircraft utilisation would be very low due to long turn around times. This inefficiency would have to be passed on to passengers in the form of higher fares resulting in reduced demand and a deadweight loss in social welfare.

This is the reason why, throughout the world, regardless of whether the airline is an LCC or an FSA, aircraft such as the Boeing 737 are commonly used on short haul routes. Further, while FSAs may use aircraft larger than Boeing 737s or Airbus A320s on very busy domestic short haul routes or at peak times, such aircraft are largely used on international long haul routes.

Medium Size Aircraft are Efficient for Airports

In addition to being efficient for airlines, aircraft of this size are also efficient users of airport aeronautical infrastructure, including aprons, gates and terminal facilities. The reasons for this are obvious: the faster turn around times of these aircraft increase utilisation of the aprons and also result in less lumpy use of terminal facilities because they deliver fewer amounts of passengers more often (meaning that the peak flow through terminals is less than it would be using larger aircraft).

In its submission, Melbourne Airport referred to the presentation by Kerry Mather, CEO of Macquarie Airports. Macquarie Airports has a number of significant airport investments, including a majority interest in SACL. Melbourne Airport stated in its submission that it was not sure of the underlying basis of the statistics used in Ms Mather's presentation and also said that in interpreting Ms Mather's presentation, the Tribunal had confused the operational models of low cost carriers with the operational characteristics of aircraft types (see p 63).

A copy of Ms Mather's presentation of February 2004 is attached to this submission. Virgin Blue notes in particular slide 24 headed "*Efficient asset utilisation – Low-fare airlines make more efficient utilisation of facilities*". This slide states:

- "*Low-fare airlines utilise capacity more effectively, based on the following factors*
    - *Simpler processing with shorter turn around times, no connections, hubbing or complex ticketing and transfer baggage facilities;*
    - *more passengers and movements per gate/stand*
    - *less peaky schedules*"

Virgin Blue considers that it is very difficult to separate out the impact of the type of aircraft used by LCCs from the impact of the LCC model when such a large part of the benefits of the LCC model relies on using medium size aircraft such as the Boeing 737 and the Airbus A320 on short haul, point to point routes. In other words, the traditional LCC model depends on using aircraft of this size and not larger aircraft. In any event, of the above factors listed by Ms Mather, most relate directly to the aircraft type used by LCCs as explained above: shorter turn around times, more passengers and movements per gate/stand and less peaky schedules.

That Melbourne Airport does not understand the efficiency benefits that are achieved through shorter turn around times is apparent from its submission, which fails to even refer to them. Indeed, Melbourne Airport comments that it is not clear that medium size aircraft[4] are more efficient users of aprons because its is possible to park two A320 aircraft on the same parking stand as an A380. Melbourne Airport notes that while A320s have 177 seats in a one class configuration, A380s are expected to have 800 seats in a one class configuration. Melbourne Airport therefore concludes that "*it is possible to park a single large aircraft that carriers [sic] 226% more passengers than two smaller ones*" (p 64). Leaving to one side the fact that no Australian airline has ordered, or is likely to order, an A380 in a one class configuration (ie all economy with no business or first class) and that no airline would ever use an A380 in a dedicated domestic role,[5] even this artificial comparison fails to account for the fact that the A380 would still be parked on the apron hours after the A320s had set off for their next flight. While no one yet has any experience in turning around an A380 with 800 passengers on board, it is likely to take longer than the two hours required to turn around the smaller Boeing 747. It is obvious that an A380 used on a short haul domestic route (say Sydney-Melbourne) would spend far more time on the ground than in the air. Indeed in a standard configuration with 555 seats, and on the basis that the turn around time for the A380 will be no more than for the Boeing 747 (ie two hours), and the turn around time for an A320 is the same as for a Boeing 737 (ie half an hour) then over a 7 hour period the A320 will make 5 one hour flights whereas the A380 will only make 3 one hour flights. In that scenario, not only will the A320s carry more passengers (1770 compared with 1665 – and therefore use the apron more efficiently), they will also do so less lumpily and by offering passengers a greater choice of flying times. It is worth remembering that for a given number of passengers, a plane that is three times larger will fly a third as often if load factors are to be maintained. Increased frequency of flights results in reduced waiting times for passengers and a lower load on infrastructure.

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4 Melbourne Airport refers to them as "small" aircraft, but as noted above, this is just not the case since they carry more than the average number of passengers.

5 Domestic terminals in Australia are currently unable to cater to A380 aircraft and have only a limited capacity to service Boeing 747 aircraft.

Per Passenger Charges "Encouraging the Use of Larger Aircraft"

While per passenger charging will penalise LCCs compared with FSAs by requiring them to pay more in landing charges and by blunting competition, it is very unlikely to result in LCCs changing the type of aircraft they use due to the other efficiency factors explained above (including shorter turn around times, greater frequency of flights and the efficiencies from having a single model fleet).

As discussed in Virgin Blue's initial submission to the Commission, the effect of per passenger charging for OzJet (while it operated) was that it paid one third of the landing fees that Virgin Blue paid to operate Boeing 737 aircraft. Importantly, it is not clear why airports should be looking to penalise airlines who are using medium size aircraft efficiently since none of the airports are currently capacity constrained.

It is therefore obvious that the effect of per passenger charging is not to encourage airlines to use larger aircraft, despite what Melbourne Airport states in its submission (see for example p 66). If an airport was truly capacity constrained and wanted to encourage airlines to use larger aircraft, the economically efficient response would be to introduce peak and off-peak pricing as stated in the Review Principles. Of course, no airport has yet done this because no airport is yet capacity constrained.

6.2 Other Efficiency Factors

In its submissions, Melbourne Airport refers to three specific matters it says support its decision to adopt per passenger charging for take off and landing: asset utilisation, damage and load factors.

Asset Utilisation

Virgin Blue has addressed the issue of airport (and airline) asset utilisation in detail above. Nevertheless, Virgin Blue would like to respond to the particular points raised by Melbourne Airport.

In this section of its submission (pp 62-64), Melbourne Airport attempts to demonstrate that medium sized aircraft such as the Boeing 737-800s used by Virgin Blue do not place less demand on an airport's assets compared with larger aircraft. To do this, Melbourne Airport focuses on a very narrow set of assets, and then only compares demand on the basis of particular criteria. Unlike the discussion above, Melbourne Airport makes no mention of terminal utilisation. Insofar as apron utilisation is mentioned, Virgin Blue has addressed this above. Further, in making its comparisons, Melbourne Airport only considers the length of the runway required for different aircraft types, not the width of the runway nor the depth of the concrete required for

different aircraft types. Obviously the length of the runway is only one driver of the cost of building and maintaining the asset.

That this analysis by Melbourne Airport is unhelpfully simplistic can be demonstrated by reference to the A380. According to Table 4.3 (p 62) in Melbourne Airport's submission, an A380 only requires a runway with a length of 3,000 m. This is shorter than the runway length required for any other aircraft listed in Table 4.3. Yet despite Melbourne Airport already having runways that were long enough for the A380, Melbourne Airport was, according to its website, required to complete "major works to upgrade the airport's apron, runway and terminal facilities"[6] to accommodate the aircraft. Similarly, Sydney Airport announced that it had to spend "over $100m" to prepare the airport for the arrival of the Airbus. Its media release dated 11 July 2005 stated:

> "*Sydney Airport Corporation Ltd (SACL) is spending over $100 million to prepare the airport for the arrival of the Airbus A380. Work includes widening of two runways as well as several taxiways, the strengthening of the General Holmes Drive tunnel; relocation of airfield navigational and visual aid equipment and the construction of aerobridges, as well as work within the International Terminal.*"

Runway length alone is evidently a poor predictor of the cost of the runway.

Damage

In this part of its submission (pp 60 and 61), Melbourne Airport argues that passenger numbers are a better proxy for aircraft damage than aircraft weight (MTOW).

This argument fails to withstand any detailed scrutiny.

Melbourne Airport argues that it has recently been determined that the damage caused by an aircraft is best measured by Aircraft Classification Numbers (**ACN**), not by aircraft weight. The reference given by Melbourne Airport is to a 2002 publication of the Irish Commission for Aviation Regulation (**ICAR**) titled *Decision of the Commission further to a Referral by the Aviation Appeal Panel of the Commission's Decision in relation to its Determination of the 26th of August 2001, on the Maximum Levels of Airport Charges* (**ICAR Decision**).[7]

Melbourne Airport then makes a calculation on the basis of aircraft and passenger arrivals at Melbourne Airport over one year to argue that passenger numbers are a better proxy of the damage caused by aircraft than MTOW. Although it is not entirely clear from Melbourne

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6 See http://www.melbourne-airport.com.au/airbus/arrivals.asp

7 See http://www.aviationreg.ie/images/ContentBuilder/cp22002.pdf

Airport's submission, it appears that to generate Table 4.2 (p 61) it has simply added together the ACNs for each flight for each airline as a proportion of the total ACNs of all flights to or from Melbourne Airport and then performed a similar calculation for MTOW and passenger numbers.

The first problem with this approach is that while you can add together passenger numbers and MTOW, this process doesn't work for ACNs. While an aircraft with an MTOW of 50 tonnes is (nominally) twice as heavy as an aircraft with an MTOW of 25 tonnes, an aircraft with an ACN of 90 does not cause twice as much damage as an aircraft with an ACN of 45. This much is clear from the ICAR Decision. For example, ICAR calculated the cost of the actual damage caused by aircraft category at p 60 of its decision. This shows that the relationship between ACN and damage is not linear:

ICAR Damage category	**ACN range and (midpoint)**	**Example aircraft**	**Average damage per movement (€)**	**Damage ÷ midpoint ACN**
8	41-46 (43.5)	737-800 (ACN 44)	144.13	3.31
13	61-63 (62)	767-300 (ACN 65)[8]	450.30	7.26

On the basis of the ICAR Decision referred to by Melbourne Airport, it is clear that the relationship between ACN and damage caused is not constant and therefore that a simple addition of ACNs is not reflective of aggregate damage caused. In fact, it is evident from the ICAR decision that the damage per point of ACN rises as the ACN increases (and is over 13 for a Boeing 747-300). This is because, as ICAR notes in the Decision referred to by Melbourne Airport:

> "*Based on the 4th power law for pavements, the damage induced by aircraft A relative to aircraft B is the ratio of the A.C.N. of aircraft A to the A.C.N. of aircraft B, all raised to the 4th power.*" (p 58)

There are many other problems with Melbourne Airport's arguments, including that ICAR decided in its decision to levy take off and landing charges on the basis of MTOW, although it did adjust the MTOW charges for different categories of aircraft to reflect the damage caused. It did not even consider charging on a per passenger basis.

[8] This ACN is from Melbourne Airport's submission. ICAR lists the ACN of the Boeing 737-300 in the range from 61 to 63.

Melbourne Airport also argues that, on the basis of the Tribunal's reasoning, per passenger charges better reflect the outcome of a competitive market because this is a better proxy for damage (p 61). However, for the reasons set out above, Melbourne Airport's supporting calculations are fundamentally misconceived. Further, even if they were not, passenger numbers may fluctuate from year to year, from flight to flight and from airport to airport and would never be a suitable proxy for the damage caused by aircraft. Finally, on the basis of Melbourne Airport's argument that it should charge in accordance with the reasoning of the Tribunal in *Re Virgin Blue Airlines* at paragraph [235] (see bottom of p 61), Virgin Blue notes that on this basis Melbourne Airport should only be charging its marginal costs of providing the Airside Service, which Melbourne Airport estimates to be around 10% of its total costs (see top of p 62). On this basis, Melbourne Airports charges are already ten times higher than they should be.

Load factors

Melbourne Airport argues at pp 65 and 66 of its submission that the Tribunal's decision in *Re Virgin Blue Airlines* was based on an argument that LCCs had higher load factors than FSAs. While LCCs often have higher load factors than FSAs, this is not an invariable rule. Further, including Pacific Blue, an international airline, with Virgin Blue (as Melbourne Airport does) will distort the load factor results.

In any event, the key point that Virgin Blue has always made in relation to the disproportionate impact of per passenger charges is that it pays more because it carries more passengers for the same type of aircraft. This is brought about not so much by a difference in load factors as by the fact that Virgin Blue has more seats in its planes than Qantas since it does not have business class and has fewer galleys. For example, while Virgin Blue has 180 seats on its Boeing 737-800 aircraft, Qantas has only 168 seats on its 737-800s.

6.3 Conclusion on structure of charging

In its submission, Melbourne Airport presents the debate as an argument over industry rents or a "distributional question" (p 59). Melbourne Airport fails to respond in substance to any of the arguments that were raised in detail before the Tribunal about the impact of per passenger charging on competition in the dependent market. These impacts included the softening of competition in the dependent market and the disproportionate impact on LCCs. While Melbourne Airport was not a party to the proceedings before the Tribunal, these arguments are summarised in the judgment (at [523] to [568]), and yet Melbourne Airport's only response is to say that "no factual evidence" was advanced before the Tribunal to demonstrate the impact on competition. Given that Melbourne Airport was not present at the Tribunal proceedings, Virgin Blue is surprised by this statement. A large number of affidavits and other documents were tendered to the Tribunal dealing with the impact of the change to per passenger charging on competition in the dependent market, and this evidence was both lay evidence and expert

economic evidence. Virgin Blue would be happy to provide this evidence to the Commission for its own review.

In the end, despite Melbourne Airport's assertion that it is not clear that, if the facts in relation to another airport had been "competently presented", the Tribunal would have reached the same decision in relation to per passenger charges, Melbourne Airport's arguments are the same as those raised by SACL before the Tribunal. While Melbourne Airport has presented some different materials to support those same arguments (ie the ACN argument and the length of runway argument), for the reasons discussed above those materials do not support Melbourne Airport's arguments.

In its submission to the Commission, SACL has presented to the Commission on p 2 of Appendix B the same arguments that failed to persuade the Tribunal. The responses of Virgin Blue (and the Tribunal) are set out in section 6.3 of Virgin Blue's initial submission to the Commission.

7. INVESTMENT INCENTIVES IN THE AIRPORT PRICE MONITORING REGIME

Airports have lauded the deregulated environment on the basis that it has seen significant investment by airports in aeronautical facilities. Virgin Blue is a strong supporter of efficient investment and recognises the benefits that it can bring to airports, airlines and the travelling public. Nevertheless, in a deregulated environment where airports are interested in justifying increased prices on the basis of new investment, and where there is limited scrutiny of those investment decisions, Virgin Blue is concerned that unnecessary and inefficient investment will be encouraged.

Theory suggests that a problem may arise in how airports make investment decisions under the current regime: the absence of a competitive market means airport users' preferences do not enter into airport investment decisions, implying that there is no natural pressure to ensure efficient levels and types of investment.

In a competitive services market, a natural mechanism exists to encourage efficient investment. Firms make individual decisions regarding what investment to make, and how much, including the quality and quantity of service provided. Users have a choice of provider — and hence are free to choose the level of service that is optimal at a given equilibrium price. Firms that invest to provide a service/price combination that is appealing to users will succeed, while firms that misjudge the market will fail or adjust their offering. This natural feedback cycle encourages firms to make optimal investment decisions.

In a monopoly services market, such as an airport, this feedback mechanism is absent. Users do not have a choice of provider, and so do not have the option to 'vote with their feet' to express

preferences regarding the service/price trade-off. Hence the discipline on airports to make efficient investment decisions is low. Coupled with the propensity of airports under price monitoring to continue to justify their price increases in terms of the costs of new projects, this may lead to inefficient overinvestment similar to the well-known Averch-Johnson effect under rate of return regulation.

In conclusion, Virgin Blue is concerned by the potential for the current regime to result in inefficient investment in aeronautical facilities. Virgin Blue considers that its proposed negotiate arbitrate model will allow for a better balance to be struck: allowing efficient investment but also providing some constraint on inefficient investment by airports.

8. RESPONSE TO NCC'S SUBMISSION

The NCC's submission states on p 14 that:

> "*An important reason for the difference between the Council's recommendation and the Tribunal's decision in regard to criterion (a) is that the parties provided new and additional evidence to the Tribunal, particularly in relation to the rationale for SACL's change to the basis for calculating the DPSC.*
>
> …
>
> *A significant amount of critical evidence was put before the Tribunal that was not put to the Council when it was formulating its recommendation. The ability to approach declaration in this way provides an incentive for parties to 'game' the decision making process and can result in divergent decisions at different stages of consideration of a declaration application.*
>
> *The Council therefore welcomes the decision of the Council of Australian Governments of 10 February 2006 (COAG 2006) to amend the Competition Principles Agreement to include a provision that, where merits review of regulatory decisions is provided, the review be limited to the information submitted to the regulator. The Council considers that this change will allow appropriate re-examination of declaration decisions while reducing the regulatory uncertainty that can result from different factual information being adduced at different stages of this process.*"

Virgin Blue notes that arguments that Virgin Blue put to the Tribunal were the same arguments that it put to the NCC during the recommendation process. For Virgin Blue's part, that the information and evidence provided to the Tribunal differed from the information provided to the NCC reflected the different procedures used by the Tribunal, and, very importantly, the additional

powers available in Tribunal proceedings which are not available in matters before the NCC. The differences did not result from any change in Virgin Blue's approach.

The NCC identifies the evidence in relation to SACL's rationale for its change to per passenger charges as the particularly important evidence that was presented to the Tribunal that was not available to the NCC. This evidence was provided to the Tribunal as a result of:

(a) Virgin Blue tendering SACL's internal documents which had been produced to the Tribunal in response to a summons to produce documents which was issued at the request of Virgin Blue (being equivalent to a subpoena in court proceedings); and

(b) Virgin Blue cross-examining SACL executives on their affidavits (which had been tendered by SACL in the Tribunal proceedings).

Without the ability to compel SACL to produce unfavourable documents and the ability to test the evidence of its representatives, the evidence in relation to SACL's rationale for moving to per passenger charging would not have been as compelling.

The NCC does not have the power to compel parties to produce documents, nor does it have the power to take evidence on oath and allow for that evidence to be tested.

Virgin Blue is therefore troubled by the NCC's support for a proposal to limit the material that can be referred to in any review of a regulator's decision in circumstances where the regulator does not have the necessary power to properly test the weight that should be accorded to the arguments advanced by interested parties. Virgin Blue submits that it is most important that the right decision be made on the basis of all the relevant information, even if that decision differs from the initial decision due to differences in the information that was (or could be) provided to the initial decision maker.

Virgin Blue also notes the NCC's comments in its submission regarding the costs and benefits associated with different regulatory models:

> "*Whether additional regulation directed at limiting monopoly profits per se is desirable is a broader question, as is the form such regulation should take. In the end this requires a value judgement that the benefits to the Australian public from constraining monopoly profits earned by airports (by whatever means this is done) exceed the likely costs of doing so in the long term.*" (p 16)

As highlighted in sections 3 and 4 of Virgin Blue's initial submission, the LCC business model is particularly sensitive to the underlying cost base, creating an incentive to minimise costs in order to stimulate additional demand for air travel. Any mandate for airports to derive monopoly

profits from the provision of aeronautical services would result in higher costs to airlines which in turn would lead to a reduction in the number of travelling passengers, owing to the high elasticity of demand for air travel. Virgin Blue believes the subsequent loss of consumer welfare (a deadweight loss to society) would be significant in the long term and is unlikely to be outweighed by any costs associated with changes to the regulatory regime for airports, particularly the alternative light handed regime Virgin Blue is proposing.

9. PRICE MONITORING SHOULD CONTINUE FOR ALL MAJOR AIRPORTS

Some of the core regulated airports have argued that they should no longer be subject to price monitoring.

Virgin Blue's position is that all of the core regulated airports plus Cairns should be subject to its proposed negotiate-arbitrate model for aeronautical services, and this model also includes improved price monitoring, as set out in section 11 of Virgin Blue's initial submission.

For the avoidance of any doubt, regardless of the any other recommendation made by the Commission, all of the core regulated airports should continue to be subject to prices monitoring. Despite the fact that the current price monitoring system is not perfect, it does still provide valuable information on airports' aeronautical prices, costs and profits.