VIRGIN BLUE

RESPONSE TO PRODUCTIVITY COMMISSION'S DRAFT REPORT

ON PRICE REGULATION OF AIRPORT SERVICES

1. Introduction

Virgin Blue welcomes the opportunity to comment on the Commission's Draft Report on *Price Regulation of Airport Services* released for comment in August 2001. While Virgin Blue agrees with the Commission's findings that major airports in Australia have a substantial degree of market power in the provision of a range of airport services, it has a number of issues with the Commission's subsequent findings and with its overall conclusions.

In particular, Virgin Blue does not consider that the Draft Report adequately addresses the specific characteristics of low fare and other new entrant airlines, or the effect that the proposed reduced regulation would have on competition in the airline industry and associated industries.

Virgin Blue therefore makes the following comments on the Draft Report.

2. Current Status of Air Travel Industry

Virgin Blue recognises that recent events affecting the air travel industry in Australia and overseas have had an impact on airports as well as on airlines and associated operators. The government has responded to this impact on a temporary basis by removing price regulation partly or completely from most core regulated airports and allowing one-off price increases in relation to the others. Virgin Blue notes that several airport operators have submitted that the current operating environment militates against continued price regulation.

However, Virgin Blue considers that the current operating environment requires continued regulation rather than reduced regulation or deregulation for the following reasons:

- Airlines have already suffered considerable cost increases due to increased security requirements and significantly increased insurance costs, the Ansett fare levy, free or discounted carriage of Ansett passengers immediately after Ansett's demise, and (particularly in the case of Virgin Blue) the unforeseen expenditure required to acquire aircraft and serve new routes. In these circumstances, any further price increase imposed by airports has proportionately greater impact on ticket prices, since low-fare carriers in particular are forced to pass on costs. These price increases lead to reduced differentiation in the market and a decrease in overall consumer welfare as price-sensitive customers are affected.

- While passenger numbers have fallen and may still be below pre-September 2001 levels, before this decrease passenger numbers were at an all-time high. Domestic passenger throughput in particular had increased by a significant amount due to the market stimulation provided by intense domestic competition and resulting low fares during the time that there were four domestic carriers. Now that Ansett is flying again and the other domestic airlines are rapidly increasing capacity and flying new routes, key airports are unlikely to experience significant loss of passenger throughput or revenue from this point forward.

- The airports from which price caps were removed by the government in October have rapidly increased their prices. Melbourne, Brisbane and Perth have all increased their revenues by the amount allowed by the government under the revised price cap, and Coolangatta and Canberra have increased their aeronautical revenues by 171% and 112% respectively. In addition, airports such as Brisbane and Coolangatta have changed their pricing from a weight-based charge to a per-passenger charge, a change that has a significant and disproportionate impacts on domestic low-fare carriers and was for that reason rejected by the ACCC in relation to Sydney airport. These price increases do not suggest that airports will be constrained from exercising their market power by the threat of future regulation, by any countervailing power held by airlines or by any other factor. Indeed, they suggest that in times of (temporary) reduced demand airports may raise their prices, creating further inefficiencies.

For these reasons, Virgin Blue considers that the issues raised in and by the Draft Report remain significant and are even more significant in the current operating environment.

3. Consequences of Market Power

Virgin Blue agrees with the Commission's findings that the operators of major city airports have market power in the provision of certain airport services. Virgin Blue considers that Sydney, Brisbane, Melbourne, Perth, Adelaide, Canberra and Darwin airports all have a substantial degree of market power due to the lack of nearby alternatives for the majority of passengers, and that Hobart, Launceston, Alice Springs and Coolangatta airports may have less market power although the market power they do have may still be significant.

Virgin Blue further agrees that the market power of these airport operators is likely to be most substantial in relation to services that are not contestable, particularly facilities required for aircraft movements (including runways, taxiways and aprons), front-door vehicle access, aerobridges when used, terminal space, check-in facilities, baggage handling and refuelling.

Although the Draft Report suggests that some of these services may be discretionary (for example, Virgin Blue does not use aerobridges), Virgin Blue does not consider this to be an

accurate test of market power. A firm is likely to have market power when its customers have no *alternative* source of supply, albeit that the customers may choose not to take supply at all. Virgin Blue therefore considers that market power may exist in relation to a wider range of airport services than are set out in the Draft Report.

(a) Incentives to Use Market Power

However, the Draft Report suggests that, while they may have a substantial degree of market power, airport operators may not have the incentive to use this market power to raise their prices to inefficient levels, since:

- airport operators have an incentive to encourage extra passengers to use the airport in order to derive non-aeronautical earnings;
- airport operators also have an incentive to price-discriminate among users in order to increase their profits to ensure that more price-sensitive users pay less and overall consumption is not affected; and
- airlines may have a significant degree of countervailing power.

Virgin Blue considers that each of these issues dramatically overestimates the incentives on airport operators not to use their market power to raise prices above efficient levels. These issues are discussed in detail below.

Non-aeronautical Revenue

Virgin Blue notes that a significant proportion of passengers, particularly business passengers, are relatively price-inelastic. Further, for these passengers the imposition of aeronautical charges may not represent a significant proportion of the overall fare. As a result, airports will have considerable latitude in pricing for aeronautical services and may increase prices for these services without substantial reduction in non-aeronautical revenues.

Virgin Blue also notes that its customers are likely to generate much less non-aeronautical revenue for airports than the passengers of full-service airlines. This is because Virgin Blue passengers:

- are exclusively domestic, and do not engage in duty-free shopping;
- use terminals that are owned by the airports (and therefore counted as aeronautical revenue, in contrast to lease payments from airline-owned terminals), are significantly smaller and have a significantly reduced range of concessions; and

- are generally more value-conscious and seek to minimise overall expenditure at airports.

As a result, any incentives to keep down aeronautical charges in order to drive non-aeronautical revenue are likely to be muted in relation to the majority of passengers. Airports will have the incentive to exploit the price-inelastic passengers who generate the bulk of non-aeronautical revenue, and will have little incentive *not* to exploit the more price-sensitive passengers who in any case do not generate the same levels of non-aeronautical revenue.

As a low-fare carrier whose passengers are likely to be more price-sensitive and who are likely to generate less non-aeronautical revenue for the reasons described above, Virgin Blue is concerned that the incentives described by the Draft Report will not be sufficient to prevent the exercise of market power to price at inefficient levels.

Price Discrimination

These considerations reduce airports' incentives to price-discriminate at the margins even where they are able to. Since the passengers of full-service airlines are likely to generate more non-aeronautical revenue than low-fare passengers, these passengers are more valuable than marginal passengers in relation to both direct aeronautical revenue and the far more significant non-aeronautical revenue generated. These conflicting incentives distort any efficiency gain available through price-discrimination, particularly where price discrimination is limited.

Virgin Blue notes that airports do not currently price-discriminate in favour of marginal passengers in any meaningful way. Most aeronautical charges are based either on a flat per-passenger basis (with no distinction between business or leisure, full-fare or discount passengers), or on the basis of aircraft weight. Virgin Blue does not consider that pricing for aircraft weight provides any meaningful price discrimination. Although Virgin Blue in general combines efficient aircraft operation (reducing weight-based charges) with more price-sensitive passengers, there is no necessary correlation between these factors, and other airlines have frequently operated very large aircraft over short distances with significant volumes of discount fares (such as Boeing 767s from Sydney to Melbourne at fares of $77) as well as operating smaller aircraft over longer distances at full international fares.

In any case, airports do not seem particularly to favour weight-based charging as a means of price discrimination or for any other reason. Virgin Blue notes that Sydney Airport recently sought to change its weight-based charges to a flat per-passenger charge.

In fact, airports only have a very limited ability to price-discriminate. They cannot discriminate directly among users and can only do so indirectly by discriminating among airlines or, at the most particular, airline flights. However, this discrimination is imperfect and is indeed inadequate.

Price-discrimination is also made difficult to the extent that major airlines have countervailing market power. For example, Virgin Blue understands that Qantas refused to pay for access to the Adelaide terminal unless Virgin Blue was charged at the same rate.

Further, while airlines have the ability to price-discriminate through yield management, there is a limit on the price increases that can be effectively "neutralised" in this way. An airport operator with market power could increase prices beyond this limit, resulting in a loss of marginal consumption and efficiency. This limit is lower for low-fare new entrant carriers such as Virgin Blue, whose passengers are on the whole more price-sensitive, than for established full-service airlines.

Countervailing Power

Virgin Blue agrees that major airlines may have some countervailing power in relation to some airports, particularly now that many destinations are served only by Qantas. However, new entrant and low-fare carriers have no countervailing power, since they tend to fly only small numbers of passengers (particularly when first commencing a route, at the time charges would be negotiated) and these passengers also tend to generate less non-aeronautical revenues.

In addition, as discussed above the countervailing power of major airlines can be used against new entrant and low-fare airlines to distort demand characteristics and promote inefficiencies. Countervailing power is not a significant remedy to the market power of the airports.

(b) Effects of Raising Prices

The Draft Report suggests that, even where airports have an incentive to raise prices, this may not result in any overall inefficiencies. This is because:

- the prices charged under existing price caps represent historical single-till prices and are insufficient for future investment;
- price increases would not have a significant effect on consumption due to the ability to price-discriminate in favour of more elastic users; and
- price increases above efficient levels would only result in a redistribution of welfare from passengers (and airlines) to airports.

Virgin Blue considers that these assumptions are unfounded and that the unconstrained ability of airport operators to raise prices above competitive levels would indeed create substantial inefficiencies throughout the system. Virgin Blue is particularly concerned that the Draft Report

does not consider the broader implications of airports' use of market power for competition in the airline industry and associated industries such as tourism.

Current Prices

The Draft Report acknowledges that average aeronautical charges are likely to rise if unregulated, but suggests that this would not produce inefficiencies since current price caps reflect a single-till legacy and are insufficient for future investment. The Draft Report considers that the introduction of the Necessary New Investment provisions "suggests that the starting prices were on the low side required for aeronautical cost recovery". It also indicates variable but overall positive operating profits and returns on assets in aeronautical services for the major privatised airports, though these are below corresponding measures for non-aeronautical services.

As set out in its earlier submission to the Commission, Virgin Blue considers that the Necessary New Investment provisions are seriously flawed and have distorted investment in airport infrastructure by insufficiently analysing whether the investment would otherwise have been made by the airport operator under the price cap or by another party. The Necessary New Investment Provisions have been exploited by airport operators and cannot be used to infer that the price caps are insufficient for future investment.

The Draft Report acknowledges that its comparison of operating profits and returns on assets for aeronautical and non-aeronautical services represents an arbitrary distinction based on airport operators' interpretation of guidelines. Though the figures cited by the Draft Report may indicate that non-aeronautical profits and returns are greater than their equivalents for aeronautical services, the evidence provided by the Draft Report is not sufficient to indicate that aeronautical revenues are insufficient for future investment.

Further, Virgin Blue rejects the Draft Report's characterisation of current prices as inefficient due to their reflection of historical single-till prices. Since aeronautical and non-aeronautical services are complementary and share significant common costs, Virgin Blue does not consider that the characterisation of prices as either "single till" or "dual till" is appropriate or helpful. It is not necessarily inefficient to recover a proportion of common costs, or even the whole of common costs, from non-aeronautical revenues. Indeed, since many non-aeronautical revenues do not depend on passenger throughput (such as lease payments) or are derived from less price-sensitive customers, it may be efficient to recover a high proportion of common costs from non-aeronautical revenues.

As a result, Virgin Blue does not accept that current prices are below efficient levels or that the unconstrained use of market power by airports to raise prices would be efficient.

Price Discrimination

As discussed above, airports' ability to price-discriminate is limited. In particular:

- weight-based landing charges do not represent meaningful price discrimination;
- airports are limited in their ability to discriminate among airlines; and
- airlines are limited in their ability to defray the consumer welfare impact of price increases through price discrimination, particularly low-fare new entrant airlines whose passengers are generally price-sensitive.

As a result, price-discrimination is unlikely to cure the inefficiencies arising from airports' use of market power to raise prices.

Redistribution Effects

The Draft Report suggests that the redistribution of welfare from passengers and airlines to airports may be neutral due to the income profiles and resident status of passengers and shareholders. However:

- as set out in Virgin Blue's earlier submission to the Commission, the redistribution from airlines to airports is a distribution from a competitive environment to a monopoly environment with greatly reduced risk profile and a correspondingly lower cost of capital: that is, the "redistribution" in fact involves a reduction in welfare and efficiency; and
- while up to 49% of airport shares are foreign-owned, all but a small proportion of passengers (and a very small proportion of domestic passengers) are Australian residents, such that the redistribution from passengers to airports results in a substantial off-shore distribution of welfare.

Competition in Airline and Tourism Markets

Virgin Blue is most concerned that the Draft Report does not consider efficiency and competition issues in the broader markets that are interdependent with the markets in which airport services are supplied.

The Draft Report's conclusions on passengers' price-elasticity of demand, airlines' ability to price-discriminate and airlines' countervailing power relate overwhelmingly to established full-service airlines. The removal of price control mechanisms from the major airports would have a

substantially greater effect on new entrant and low-fare carriers than it would on these full-service airlines.

New entrant low-fare airlines typically carry a higher proportion of price-sensitive passengers travelling on discount economy fares (which are themselves discounted from lower full economy fares), and generally have no business class seating and carry a fewer business carriers. As a result, airport charges constitute a higher proportion of the ticket price in a segment where even small changes to price can have a significant impact on demand. The flatter range of price-elasticity among low-fare carriers' passengers greatly reduces the airline's ability to price-discriminate in order to apply airport price increases without reducing demand.

Further, as discussed above, new entrant airlines have no countervailing power against airports' market power. While incumbent full-service airlines may have countervailing power, this may be applied to airports in order to raise new entrant airlines' costs and prevent price discrimination in favour of new entrants.

As a result, even if increases in airport costs did *not* drive down demand for airline services (and Virgin Blue contends that it would), there would be a significant loss of allocative efficiency due to the discouragement of new entrant airlines. That is, even if consumption of airline services was not reduced, neither would it be stimulated in the way that it has been by the introduction of low-fare services throughout the world and demonstrably in Australia.

Due to the factors described above, unregulated airport charges present a real barrier to new entry and expansion by low-fare carriers. Even if the exercise of market power to raise airport charges could be justified as efficient when considering airports in isolation (and Virgin Blue considers that it cannot), it is likely to discourage or prevent the new entry required for vigorous competition in the airline industry and related industries such as tourism. This is of course particularly important since the collapse of Ansett as a full-service carrier.

4. Appropriate Form of Regulation

(a) Prices

The Draft Report concludes that:

- incentive regulation should only be used where excessive pricing would otherwise be likely to result in significant efficiency, since it can be inadequate for investment, discourage commercial negotiation, encourage gaming and impose increased compliance costs; and

- in this case, price monitoring is to be preferred as a less intrusive method of regulating prices, chiefly through publicity and the credible threat of stricter regulation.

Virgin Blue disagrees with the Draft Report's conclusions.

Need for Incentive Regulation

Virgin Blue has expressed its concerns with the Necessary New Investment provisions of the current regime. However, these are not concerns with the imposition of a price cap itself. Virgin Blue considers that the price cap can provide incentives for new investment within the price cap framework by encourage investment that promotes increased efficiency and expanded output. Investment in aeronautical services that promotes non-aeronautical revenue will also be encouraged within the price cap framework. Service requirements and quality of service standards can also be incorporated into the price-cap framework to provide incentives for investment.

The Draft Report does not provide illustrations of the type of "regulatory gaming" encouraged by incentive regulation. However, Virgin Blue considers that the same issues of gaming and compliance costs are equally likely to arise in cases of price monitoring, and that the details of the regulation imposed (such as service standards and new investment criteria) are as important as the general form of regulation in this regard. In relation to commercial negotiation, Virgin Blue notes that the ability to negotiate appropriate commercial terms is in any case not available to airlines (particularly new entrant airlines) where an airport has a substantial degree of market power.

As discussed above, Virgin Blue considers that, in the absence of regulation, excessive pricing by airport operators with substantial market power would result in significant inefficiencies in the provision of airport services and, more broadly, would substantially discourage competition and reduce efficiency and welfare in the airline and tourism industries. Virgin Blue therefore considers that an appropriate form of incentive regulation, including mandatory price caps, is justified and indeed required.

Price Monitoring

Virgin Blue considers that the price monitoring framework proposed by the Draft Report is a weak and inadequate solution to the market power enjoyed by airport operators. The proposal would create significant uncertainty in the industry and would promote a wide range of regulatory gaming behaviour. For example, airport operators could reap very high monopoly rents in the five years of the monitoring if they thought either that increased regulation would not be implemented or that the increased regulation would still be "worth it". Alternatively, they could

use their market power to raise prices to a lesser but still significant and inefficient degree until the end of the probationary period, then raise prices even higher after that period had ended.

In the meantime, airlines would have no recourse apart from costly litigation under the *Trade Practices Act 1974.* In the airline industry, where most participants are vulnerable, this recourse is completely inadequate and cannot hope to prevent the exercise of market power by airports from having an extremely significant impact on competition, new entry and efficiency. Virgin Blue notes that the price monitoring regime applying to New Zealand airports has resulted in significant price rises and a high degree of uncertainty and litigation.

(b) Access

The Draft Report also recommends that access to airport services be regulated using declaration criteria no broader than those found in Part IIIA of the *Trade Practices Act 1974,* and further that declaration be effectively subject to additional criteria: that the price monitoring regime had demonstrably and irrevocably failed, and that an airport's behaviour was such as to be causing significant efficiency losses.

While Virgin Blue does not see regulated access as a substitute for price control, it is an important complement to it and can apply, for example, when access to particular services or facilities is unavailable at all or except at prices that are inappropriately high even though within the overall price cap.

Virgin Blue considers that a separate access regime for airport services is necessary due to the unique characteristics of the industry and in order to streamline the declaration process to deliver timely and meaningful results. It also considers that the criteria for declaration should be considered carefully to ensure that they are the appropriate criteria for the industry. It strongly disagrees with the Commission's proposal that additional criteria should apply beyond the Part IIIA criteria, particularly such vague criteria as the demonstrable and irrevocable failure of the price monitoring regime.