NON-CONFIDENTIAL VERSION

PRICE REGULATION OF AIRPORT SERVICES

RESPONSE TO THE

PRODUCTIVITY COMMISSION'S DRAFT REPORT

FROM VIRGIN BLUE AIRLINES

17 October 2006

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1 INTRODUCTION AND EXECUTIVE SUMMARY

Virgin Blue Airlines Pty Limited (**Virgin Blue**) welcomes the opportunity to respond to the Draft Report *Review of Price Regulation of Airport Services* (**Draft Report**) published by the Productivity Commission (**Commission**).

Contrary to the Commission's expectations, Virgin Blue does not consider that the Draft Recommendations set out in the Draft Report will lead to increased commercial negotiation between airports and their customers of the sort that would occur in competitive markets.

Indeed, Virgin Blue considers that the outcome of the regulatory environment recommended by the Commission will be that airports will continue to push the envelope and test the extent to which they can exercise their market power to increase their profitability (to the detriment of society as a whole) without reaction from the Government. Virgin Blue considers that the regulatory environment recommended in the Draft Report will result in:

- airports continuing to increase the revenue they generate from aeronautical charges with the result that they will over-recover the efficient costs of providing such services to an even greater extent;

- airports continuing to structure charges to maximise their profits regardless of the efficiency of such charges (as demonstrated by international best practice) or the effect that such charging structures have on competition in the dependent airline industry; and

- discussions between airports and airlines continuing to degenerate into "show negotiations" where airports meet with airlines to inform them of the decisions they have already made and the charges they have decided to impose solely so that they can say that they have held discussions with airlines.

The actions of the airports described above have led, and will continue to lead, to monopolistic and inefficient charges for aeronautical services. These charges in turn result in reduced consumption of airline services and a deadweight loss to society. Increased aeronautical charges *do* have a material impact on passenger demand. The impact is not negligible, nor is it just a matter of a wealth transfer from airlines to airports. Further, competition in the dependent airline industry will also be adversely affected by these actions (as low cost carriers will be disproportionately impacted by the changes), which will result in further losses in social welfare.

Virgin Blue submits that, contrary to the findings in the Draft Report, major airports' revenues from aeronautical charges *have* increased significantly above efficient costs since light handed regulation was introduced. Virgin Blue refers to the analysis of the Allen Consulting Group which clearly demonstrates the increase in monopoly profits. Rather than an actual analysis of revenues against costs, in the Draft Report the Commission relies on two comparisons to support

its views that revenues are not substantially above efficient costs: a comparison with international charges at international airports, and a comparison with smaller, unmonitored airports in Australia. However, the conclusion that the Commission draws from these comparisons is flawed, and considered analysis of these comparisons shows that the charges of major Australian airports are significantly higher than they should be. As the consultants retained by Melbourne Airport noted, Australian airports as a group are the most profitable in the world. Indeed, in the survey of international airports referred to by the Commission, those same consultants found that Australian airports accounted for 4 of the 11 most profitable airports in its survey (see section 4.3 below).

This result is not, and should not be, surprising. Major airports have substantial market power and face no effective constraint on their exercise of this market power. It has been empirically demonstrated that the constraint previously identified by the Commission in its earlier report, the constraining effect of non-aeronautical revenue, would be ineffective in preventing major airports from increasing their aeronautical charges to many multiples of their current level.

Despite this, the Commission has been unable in the Draft Report to identify any other effective constraint on airports' market power. While some reference is made to the threat of re-regulation, it is widely accepted that this threat is not effective unless the trigger point is clear and the sanctions are sufficient to act as a deterrent. This is not the case with the current price monitoring regime, as was submitted by the regulator charged with the responsibility for conducting the price monitoring, the Australian Competition and Consumer Commission (**ACCC**). Even the Commission admits in the Draft Report that the effectiveness of this constraint is far from certain.

Given that airports are unconstrained monopolists, Virgin Blue submits that the outcome without effective regulation is clear. While the continued increase in charges by airports above efficient levels might occur more slowly than would be the case with some other industries, and while the reasons for increases in charges might be masked by airports, charges will continue to increase above efficient levels.

Other Australian industries, such as the telecommunications, gas and electricity industries, that depend on services provided through significant monopoly infrastructure do not rely merely on price monitoring to ensure efficient terms and conditions for access to that infrastructure. Instead, a variety of other mechanisms, such as negotiate-arbitrate models and/or access undertakings are used to ensure that prices charged by access providers do not rise significantly above efficient costs. Virgin Blue does not see any legitimate reason why the aviation industry, with its reliance on monopoly airports, should be an exception to this rule.

Rather than improving the constraints on the market power of major airports, the Commission's Draft Report proposes (if anything) to weaken them. In recommending that price monitoring only occur every two years and that Darwin Airport be excluded altogether, the Commission has

reduced the effectiveness of price monitoring (to the extent it has any ability to constrain the conduct of major airports). The Commission finds that the effectiveness of price monitoring in constraining the exercise of market power by major airports will be greatly enhanced if the ACCC is required to collect commentary from industry participants and then include it in its report to the Government. Given the sophistication of the industry participants, and their independent ability to communicate with each other and the Government, it is hard to see how this change would make any difference.

For the reasons discussed above, Virgin Blue is disappointed by the Commission's draft finding that a negotiate-arbitrate model for aeronautical services provided by major airports is not warranted. Virgin Blue considers that such a model offers the industry the best hope of preserving the benefits of commercial negotiations while providing an effective constraint on the market power of major airports. The only other regulatory models that will impose sufficient constraint on airports to avoid considerable losses in social welfare would be far heavier handed (such as a price control model).

While Virgin Blue considers that commercial negotiation provides maximum flexibility to the parties, this preference for commercial negotiation is conditioned on there being effective constraints on the conduct of major airports – no customer would willingly choose to deal with an unconstrained monopolist. Therefore, while Virgin Blue is a strong supporter of the negotiate arbitrate model, Virgin Blue considers that if the alternative is an ineffective light handed regulatory regime of the sort recommended by the Commission, it would prefer to have price controls reintroduced as they would offer greater net benefits for airport customers, passengers and society as a whole.

Virgin Blue does not agree with the Commission that parties would not have sufficient incentives to negotiate with each other if a negotiate arbitrate model was introduced. It is hard to understand why parties would choose to go to arbitration as a default position given the costs and uncertainties attendant on that process, especially if, as recommended by Virgin Blue, the ACCC were to issue detailed guidance on pricing related matters. Negotiate arbitrate models have worked well in other industries (indeed, it is the model underpinning the National Access Regime) and there is no evidence that they result in parties having insufficient incentives to negotiate. Under a negotiate-arbitrate model, there are a number of ways in which parties may be further encouraged to negotiate before resorting to arbitration, including final offer arbitration and cost penalties for those who resort unreasonably to arbitration.

However, Virgin Blue does not consider that there is a demonstrated need for any such measures. Given the experience in other industries (and in the aviation industry) to date, there is no reason to believe that parties will resort to arbitration excessively. Nevertheless, to cater for any concern that this might occur, Virgin Blue considers that it would be appropriate for the Commission to be asked to review the operation of the negotiate-arbitrate model after an initial probationary period

(say three to five years) and to recommend the adoption of any mechanisms deemed necessary to improve the effectiveness of the model.

In relation to asset valuations, Virgin Blue welcomes the Commission's view that ongoing asset revaluations on the basis of opportunity costs should not be permitted. However, Virgin Blue does not consider that June 2005 is the appropriate date at which to freeze airports' asset valuations. Instead, for the reasons discussed in Chapter 3 of the attached report from the Allen Consulting Group, the starting asset values for airports should be those values implied from the prices allowed under the previous price cap regime, which is consistent with the approach taken in many other industries.

2 THE RELEVANCE OF AIRPORT CHARGES

2.1 Why airport charges for aeronautical services matter

Virgin Blue is disappointed that the Commission has failed to recognise the importance to airlines of airport charges for aeronautical services. The Commission's position ignores the consequences that increases in aeronautical charges can have for competition in the airline industry, for the travelling public and for society as a whole.

As set out in Virgin Blue's earlier submission to the Commission, Virgin Blue considers that airport aeronautical charges are a significant part of its cost base, and Virgin Blue is forced to try to pass on to its passengers at least part of any increases in aeronautical charges, resulting in reductions in demand and a loss in consumer welfare.

The clear link between aeronautical charges, airfares and reduced consumption of air travel (and consequent monopoly deadweight loss) was recognised by the Commission in its 2002 report on the price regulation of airport services.[1] However in the Draft Report, the Commission suggests that significant increases in aeronautical charges by major airports would not have significant effects. For example, the Commission states:

> "*But even if charges [at Sydney Airport] were to rise by 20 rather than 10 per cent, and were passed on in full to airlines passengers, the* ***percentage*** *impact on ticket prices would be very small.*" (emphasis added)

Virgin Blue is surprised by this analysis – just because a *percentage* impact on airfares may not be large does not mean that the actual reduction in consumption of air travel and dead weight loss will not be significant, especially in circumstances where (as is universally recognised) demand for air travel is relatively elastic. As set out on p 22 of Virgin Blue's submission dated 21 July 2006, even if airlines only passed on half of a 10% increase in aeronautical charges by

[1] Productivity Commission, *Price Regulation of Airport Services*, Inquiry Report, 2002 , pp 80 and 83

Sydney Airport, this alone would result in [**CONFIDENTIAL**] fewer passengers travelling every year. As the Commission would appreciate, an analysis of the percentage impact of an increase in prices without any consideration of what the effect of that percentage increase would be, does not assist in analysing the economic effect of the increase. While 1%, 2%, or even 5% may not be a large percentage change, the effect of such an increase can obviously be very significant when the size of the industry is taken into account.

In its Draft Report, the Commission downplays the significance of airport charges for aeronautical services in other ways. For example, the Commission notes that revenue from those charges is less than revenue from government provided services.[2] Virgin Blue does not consider that that is a useful comparison for assessing the importance of those charges.

Further, in the domestic context, the only Government supplier of aeronautical services is AirServices Australia, and while it is a monopoly supplier, the services it supplies (unlike those supplied by monopoly airports) are subject to formal price control through prices notification.

In any event, rather than comparing the aeronautical charges of airports with those levied by Government, it is more meaningful to assess the revenue derived by airports from aeronautical services with the efficient costs of providing those services (in accordance with the Government's Review Principles).

Further, it must be recognised that aeronautical charges are a significant cost when compared with the price of commonly offered air fares. Virgin Blue set out those comparisons in its earlier submission.[3] A summary is reproduced below.

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2 Draft Report, p 10

3 Virgin Blue submission, 21 July 2006, pp 19-20 [**CONFIDENTIAL**]

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The table above shows that aeronautical charges constitute a significant proportion of Virgin Blue's commonly offered fares.

The relative magnitude of these charges can also be seen when aeronautical charges are compared to airlines' annual profits. The table below sets out a summary of Virgin Blue's analysis from its earlier submission of aeronautical revenue as a proportion of pre-tax profit per passenger.

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As can be seen from the above table,[4] aeronautical charges are substantial when compared to Virgin Blue's pre-tax profit.

These comparisons are important because they show the impact that any increase in airport aeronautical charges can have.

As discussed in detail in Virgin Blue's earlier submission to the Commission,[5] increases in aeronautical charges are likely to have the following effects:

(a) an increase in at least some fares, or a reduction in the availability of discounted fares;

(b) an associated drop in the number of passengers, given that demand for domestic air travel is relatively elastic;[6] and

(c) a consequential deadweight loss for society.

The Commission notes in the Draft Report[7] that some have questioned the validity of an argument that increases in airport charges will have a greater impact on low cost carriers (**LCCs**) than on full service airlines (**FSAs**). Virgin Blue submits that the validity of the argument cannot be doubted; the LCC business model depends on minimising costs to stimulate additional demand through offering lower fares. An increase in aeronautical costs will hinder an LCC's ability to do so. This issue is discussed in more detail in section 4.4 below.

For the above reasons, the Commission should recognise the importance of airport aeronautical charges, and the significance of those charges not only for airlines (and in particular LCCs) but also for the travelling public and, therefore, overall social welfare.

3 WHAT CONSTRAINS THE AIRPORTS' USE OF MARKET POWER?

For Virgin Blue, the most troubling aspect of the Commission's Draft Report is that it fails to identify any factor that will effectively constrain airports from using their market power to increase prices and engage in other price and non-price conduct to increase their profits to the detriment of airlines, their passengers and overall social welfare.

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4 Virgin Blue submission, 21 July 2006, p 21

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5 Virgin Blue submission, 21 July 2006, pp 21-23

6 See *Application for Declaration of the Airside Service at Sydney Airport*, Frontier Economics, 12 August 2006 at paragraph [60]

7 Draft Report, p 9

In its first (2002) review of the price regulation of airport services, the Commission found that a number of airports had market power (including some with substantial market power).[8] However, the Commission decided that price controls were not "required" (even at those airports with substantial market power) because airports' market power was "*constrained by commercial pressures and opportunities, particularly the substantial 'non-aeronautical' income to be had from promoting airline passenger traffic.*"

As discussed below, while these commercial pressures and opportunities, particularly the constraint of non-aeronautical revenue can be shown to have some effect at the margin, they have been demonstrated to be ineffective to prevent airports from raising prices substantially above efficient costs.

For example, the Australian Competition Tribunal (**Tribunal**) in *Re Virgin Blue Airlines Pty Limited*[9] (**Re Virgin Blue Airlines**), considered constraints on Sydney Airport's pricing behaviour in detail and concluded:[10]

> *"We are satisfied that the ability of SACL to exercise monopoly power in relation to the airlines' use of the Airside Service is not subject to any effective constraints. We do not consider that the airlines have any significant countervailing power, or that the threat of re-regulation by the Commonwealth Government is an effective constraint upon SACL, or that SACL's ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL's monopoly power."*

The findings in this decision, which forms part of the Commission's Terms of Reference, apply equally to (at least) the other major airports in Australia. Despite these constraints having been revealed to be ineffective, the Commission has been unable to point to any other source of significant constraint on airports' market power.

The "constraints" considered by the Commission are:

(a) the threat of re-regulation and Part IIIA of the *Trade Practices Act*;

(b) the constraint of non-aeronautical revenue;

(c) that growth in passenger numbers will be a "source of downward pressure" on airport prices;

(d) that airlines have countervailing power; and

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8 Productivity Commission, *Price Regulation of Airport Services*, Inquiry Report, 2002 , p xvi

9 [2005] ACompT5

10 at paragraph [18]

(e) the increasing importance of low cost carriers flying point to point and withdrawing services if they are not profitable.

We discuss each of these below.

3.1 Threat of re-regulation and Part IIIA

Of these, only the threat of re-regulation and Part IIIA of the *Trade Practices Act* are considered in any detail, and even then the Commission is unable to decide itself how effective these constraints may be. At times, the Commission appears certain that these constraints will be effective, for example where the Commission states (p 112):

> "*The market power enjoyed by airports will, of course, condition negotiations and the outcomes they deliver. However, such power is already catered for through price monitoring – which the Commission has proposed should continue after 2007 – and the Part IIIA regime.*"

In relation to Part IIIA of the TPA, the Commission then acknowledges that Part IIIA is costly and time consuming to access and that there are also uncertainties as to its general applicability. Virgin Blue agrees with these observations from the Commission. For these and the other reasons outlined in section 8 of Virgin Blue's submission to the Commission dated 21 July 2006, Part IIIA is an ineffective constraint on the market power of airports.

On the question of the constraint imposed by the threat of re-regulation, the Commission is elsewhere less sanguine. In Attachment D to the Draft Report, the Commission examines the potential factors that might constrain the conduct of Sydney Airport. The Commission considers the countervailing power of airlines, the influence of non-aeronautical revenue and the threat of re-regulation. On p 165 the Commission concludes that these factors:

> "*will serve to impose some constraint on SACL's incentive and scope to exercise market power. That constraining effect may not be large.*"

Later on the same page, the Commission then refers to this constraint as far from certain:

> "*And if price monitoring operates to constrain overall airport revenue, the linkage of charging structures to misuse of market power becomes even less clear.*"

On p 53 of the Draft Report, the Commission states that it is still too early to judge whether price monitoring will:

> "*provide a realistic constraint on the exercise of market power as the influence of the previous regulatory regime recedes …*"

There is a widespread consensus on what is required in order for a threat of re-regulation to be effective: there is no need to wait another 5 years in order to be able to judge whether the threat is likely to be effective to constrain the conduct of airports with market power. For any threat of re-regulation to be effective in constraining the exercise of market power:

(a) there must be clear criteria for triggering sanctions;

(b) the regulator must be able to identify when these criteria have been met; and

(c) the sanctions must be sufficient to deter firms from engaging in the undesirable conduct.

For example, these issues have been considered by Dr Peter Forsyth, Professor of Economics at Monash University, who stated, in 2004 (emphasis added):[11]

> *"Consider, first of all, the sanctions proposed for the airports. Will they be sufficient to deter unsatisfactory behaviour (whatever it is)? If the sanction is imposed, the airport will be price regulated, and probably profits will be modest – the regulator will aim to set prices which cover all costs and no more. Without this regulation, the airport will have more pricing flexibility, and will be able to earn higher profits in the long run, at least after the decision has been taken not to implement regulation.*
>
> …
>
> *The airport will realise that the probability of the sanction being imposed will vary according to its behaviour. The more it raises its price above what it considers the safe level, the greater will be the probability of the sanction being activated. The airport will have to choose a price level for the short term which maximises expected profits over the long term, and the risk of price regulation will motivate it to keep its prices below the short run profit maximisation level. Thus, the threat of imposition of regulation will be a real sanction, although how strong a sanction it will prove to be has yet to be seen. <u>The effectiveness will depend on how precise is the relationship between exceeding the bounds of satisfactory performance and activation of the sanction. If the sanction is automatically activated even for very small deviations from satisfactory performance, it will be a moderately strong sanction. If considerable leeway is given between actual and defined satisfactory performance before the sanction is activated, the sanction will be less effective</u>."* (emphasis added)

The current "light handed" regulation of aeronautical services fails each of the requirements set out above:

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[11] Forsyth, "Replacing Regulation: Airport Price Monitoring in Australia", in Forsyth et al (ed), *The Economic Regulation of Airports* (2004), p 14

(a) although it is clear that prices should generate expected revenue that is not significantly above the long run costs of efficiently providing aeronautical services on a 'dual till' basis, it is not clear when the Government's Review Principles would be contravened, ie what level or structure of charges, or what non-price conduct would contravene the Review Principles;

(b) even the ACCC concedes that the information it collects is insufficient to consider the economic cost questions raised in the Government's Review Principles;[12] and

(c) the sanction is stated to be the re-introduction of price controls – this is a poor deterrent since airports would not be required to disgorge any excess profits they had earned. For example, Dr Philip Williams concluded in his report to the Tribunal:[13]

> *"The extent to which the threat of re-regulation might constrain SACL's pricing of the Airside Service can be assessed with the aid of the economic analysis of law enforcement. This framework suggests that two considerations are relevant to the assessment: (i) that the threat of re-regulation as outlined by the Government would not be triggered by a substantial increase in the price of the Airside Service; and (ii) if it were triggered, the penalty imposed would merely be to return SACL to the pricing levels of the counter-factual. This leads to the conclusion that pricing of the Airside Service without declaration would rise significantly compared with the same time path that would be followed if the Service were declared."*

Indeed, in its Draft Report, the Commission has recommended new arrangements with even less effective sanctions than those contained in the Government's Review Principles. For example, the Commission has recommended (p 57, Draft Recommendation 4.1) that there should be a modified price monitoring regime under which, if the monitoring process reveals strong evidence of significant misuse of market power, then detailed scrutiny of that airport's prices would occur. All this does is to add in another lengthy step (a Part VIIA price inquiry) before any actual sanction is imposed. On the basis of Professor Forsyth's test, the sanction of re-regulation would not be effective, as the steps that would need to take place before the sanction was introduced are lengthy, and it is by no means clear when the sanction would be triggered.

Nor does Virgin Blue consider that the amendment to the price monitoring regime proposed by the Commission will make any relevant difference either to the ability of the Government to detect whether the Review Principles are being complied with nor to the ability of airlines to have relevant information on the basis of which to negotiate with airports.

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12 ACCC, "Submission into the Productivity Commission's Inquiry into Price Regulation of Airport Services", August 2006, sec 3.2.4

13 at paragraph [87]

The Commission has recommended that the monitoring process should make explicit provision for airports and those using monitored services to comment on the reasonableness of charging and related outcomes, and require the ACCC to include that commentary in its reports. The Commission believes that providing this commentary will somehow render more credible the threat of stricter price controls if "there is a costly misuse of market power".[14] The Commission goes on to state (p 57)

> "*In sum, the Commission considers that placing greater emphasis on reporting the views of the key stakeholders under the new price monitoring regime would both:*
>
> - *continue to encourage the development of commercial relationships between airports and their customers and timely negotiated outcomes; and*
>
> - *provide better signals on whether there has been any significant misuse of market power by airports. In so doing, it would help to address one of the key concerns of airlines and other users about the operation of the current arrangements.*"

Virgin Blue does not see how the provision of commentary to the ACCC by stakeholders and the inclusion of that commentary in the ACCC's price monitoring reports will make any difference to the credibility of the threat of re-regulation or the development of commercial relationships between airports and their customers.

In relation to the development of commercial relationships between airports and airlines, each is already perfectly capable of providing its commentary on prices to the other directly. Virgin Blue does not see how the Commission's proposal will assist the development of these relationships. Virgin Blue's problem is not that it is unable to put its views to airports, it is that some airports ignore those views in pursuit of their own profits.

Similarly in relation to the credibility of the threat of re-regulation, each party is already capable of expressing its views on the level of aeronautical charges to the Government. Virgin Blue fails to see how the ACCC merely passing on the industry participants views to the Government unedited will improve the (very low) credibility of the threat of re-regulation.

3.2 Other potential constraints on airport market power

In addition to price monitoring and Part IIIA, the Commission, and various submitting parties have referred to other potential constraints on the exercise of market power by airports. For the reasons set out below, none of these constraints, either individually or in combination, constrain a

[14] Draft Report, p 55. As noted elsewhere in this submission, the relevant test for the Government is whether there has been a contravention of the Review Principles, and those principles do not refer to a costly misuse of market power but to revenues exceeding efficient costs.

major airport from increasing its aeronautical revenue significantly above the efficient costs of providing aeronautical services.

A Constraint of non-aeronautical revenue

It has been clearly shown that the constraining effect of non-aeronautical revenue would not be significant unless aeronautical charges were increased to many multiples of their current levels.[15] By way of example only, Sydney Airport's expert economist in *Re Virgin Blue Airlines* found that, on the basis of a demand elasticity for air travel of -1, this constraint would not prevent Sydney Airport from increasing its charge for the Airside Service from approximately $3.00 to $58.00.

The Tribunal stated at paragraph 512 of *Re Virgin Blue Airlines* that:

> "*If there was to be any constraint as a result of non-aeronautical revenues, that would only occur if the Airside Service charges were raised to levels substantially higher than they are presently set at.*"

Virgin Blue does not understand the basis for the Commission's statement in relation to the constraining effect of non-aeronautical revenue that "*it may not be appropriate to automatically generalise the Tribunal's assessment, based as it is on circumstances at Sydney Airport*."[16] While the precise level of charges at which the constraint will be effective will vary from airport to airport, given that the level for Sydney Airport is more than 15 times the current level of charges, there would have to be something extraordinarily different about a particular airport for the constraint to become effective at an acceptable level, ie for the constraint to prevent the airport from recovering aeronautical revenue significantly above efficient costs.

In this regard it is telling that not one airport has attempted to perform the calculation to show that the constraint would, in fact, be effective given its particular circumstances.

Instead, just two airports referred to this issue in any detail in their submissions to the Commission, and even then they only referred generally to the concept of the constraining effect of non-aeronautical revenue. As Perth Airport states on a number of occasions in its submission:

> "*Passenger throughput is a key driver of non-aeronautical revenue, and aiports have a clear incentive to grow passenger throughput by offering competitive prices for aeronautical services and by delivering improvements in service quality.*"[17]

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15 See for example the discussion set out at section 9 of Virgin Blue's submission to the Commission dated 21 July 2006

16 Draft Report, p 162

17 Westralia Airports Corporation Submission (No 20), p 24

However, as noted above, Perth Airport made no attempt to show that this constraint would be effective to prevent it from levying aeronautical charges above efficient levels. Indeed, if this statement was correct, and passenger throughput was the key driver, then airports would not charge at all for aeronautical services. This is not the case. The key driver for privatised airports is, of course, profit maximisation, and it is clearly the case that until aeronautical charges reach atmospheric levels, the amounts airports gain from increasing aeronautical charges far outweigh any losses from reductions in non-aeronautical revenue, making increases highly profitable.

In relation to this issue, the Commission concludes:

> "*At the same time, the Commission acknowledges that it would be similarly inappropriate to base the case for a light-handed approach to prices oversight solely, or primarily, on this constraint.*" (Draft Report, p 162)

Virgin Blue considers that all of the available evidence indicates that it would be inappropriate to base the case for a light-handed approach to prices oversight to any extent on this constraint.

B Growth in passenger numbers

The Commission states that:[18]

> *"…the stronger than anticipated passenger growth in recent years, and an expectation of steady growth for the foreseeable future, will enable airports to spread fixed costs over a considerably larger passenger base. This should put downward pressure on prices, especially given that the now greater reliance on passenger-based charging…allows airports to capture a greater share of the benefits of demand growth."*

Virgin Blue agrees that growth in passenger numbers will reduce airports' unit costs and should therefore lead to a price decrease. However, while an increase in passenger numbers will provide the *scope* for price reductions, the price reductions will not necessarily occur. The reason for that is that there is in fact no "downward pressure". Given the lack of a competitive environment, in the absence of effective regulation, airports can simply increase their profits, rather than reducing their prices. The Commission has acknowledged that this could constitute an exercise of market power:[19]

> *"…in the absence of [significant new investment], and with strong growth in passenger numbers, even constant charges might be indicative of the exercise of market power by an airport."*

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18 Draft Report, p 25

19 Draft Report, p 84

In addition, Virgin Blue submits that, rather than allowing airports to "capture" demand growth, per passenger charges for take off and landing services in fact allow airports to *exploit* passenger growth. As discussed in section 4.4 below, the cost drivers for the use of airside services are not passenger based, and there are no efficiency benefits associated with per passenger charges. The Commission is correct in finding that per passenger charges will lead to increased revenues as passenger numbers increase, but should understand that this increase will be as a result of inefficient charging structures, and this will exacerbate the negative efficiency consequences of airports' over-recovery of their costs.

C Countervailing power of airlines

In *Re Virgin Blue Airlines*, the Tribunal stated that the definition of countervailing power asks whether a party can create a credible threat to withdraw from negotiations or whether the party must accept a "take it or leave it" offer.[20]

Virgin Blue set out its experiences in negotiating with airports in its earlier submission. Virgin Blue has found that major airports will generally just announce changes to take off and landing charges and any consultation that may be required under any agreement will be perfunctory. Such changes are generally presented to Virgin Blue on a "take it or leave it" basis.

However, the Commission finds that airlines do have countervailing power because they can withdraw or reduce the number of services they offer (in particular at smaller airports) (see for example Box 4.5 on page 59). If aeronautical charges increase, airlines must try to pass some of those increases through to their customers. Inevitably, some customers will pay increased prices and some will choose not to fly. The proportion of passengers choosing not to fly will depend on the size of the increase and the elasticity of demand (and demand for air travel is elastic). If charges are too high for an airline to make a profit on a route, then it may choose to withdraw or reduce the number of services it offers. In either situation, the result will be a deadweight loss to society. However, given that aeronautical charges are but one cost component that goes into airfares, it is most likely that an airport (regardless of its size) will be able to increase its prices for aeronautical services well above its efficient costs of providing those services without suffering any net loss of revenue from reduced passenger numbers (this issue had been canvassed at length in relation to non-aeronautical revenues). For this reason, Virgin Blue does not believe that it has any significantly countervailing power even when dealing with airports that depend on holiday or leisure traffic.

The Tribunal stated in relation to Sydney Airport that:[21]

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20 *Re Virgin Blue Airlines*, paragraph [484]

21 *Re Virgin Blue Airlines*, paragraphs [485]-[486]

"*We consider that Qantas and Virgin Blue's bargaining power in relation to resisting any increase in charges, whether justifiable or otherwise, is extremely limited because they have no alternative avenues open to them other than to use Sydney Airport.*

Sydney is critical to Qantas' network and to Virgin Blue's activities. Neither of them, nor any other airline operating aircraft of comparable size, has any alternative location for its airline activities. The evidence was that Sydney Airport is the only airport available for commercial airline services flying to Sydney…"

The Commission tries to distinguish the Tribunal's consideration of countervailing power on the grounds that the position of Sydney Airport is different. While it is true that the sizes of the other price monitored airports differ, it is Virgin Blue's experience that "take it or leave it" offers are not unique to Sydney. In addition, the monitored airports are the largest and most important airports in Australia.

Finally, in the Draft Report the Commission implies that airlines have an ability to influence airports through "*playing the 'media card' or tying up management resources (being 'difficult' customers)*" (p 59). Virgin Blue considers that these are the actions of a party that does not have any significant power (bargaining or otherwise) and it is hard to see how they could be relied on to form any part of an effective constraint on the market power of airports.

Virgin Blue notes that the Tribunal also dismissed arguments from SACL that airlines had countervailing power through the media:

"*The final result is that any countervailing power the airlines have is limited to legal proceedings, media campaigns and lobbying for regulation. We see these as relatively weak bases of countervailing power which are generally related to, and dependent upon, the regulatory environment.*" (at [498])

D Increasing importance of LCCs

The Commission states that the increasing importance of LCCs flying point to point and withdrawing services if they are not profitable will increase competition among major airports.[22] The Commission appears to consider that this will in some way influence the pricing behaviour of airports to keep aeronautical charges down, although this point is not further elaborated.

Virgin Blue does not see how increased competition of the sort that has been experienced by the aviation industry since Virgin Blue's entry and the introduction of the low cost carrier model[23] would constrain the exercise of market power by airports. Indeed, increased competition has the opposite effect – it reduces any countervailing power an airline might have in bargaining with an

[22] Draft Report, p 1

[23] This impact and its causation is discussed in Virgin Blue's submission to the Commission dated 21 July 2006 at pp 14-16.

airport. This issue is discussed further at p 16 of the attached report from the Allen Consulting Group.

3.3 Impact of an absence of effective constraint

Given that the Commission cannot point to any constraint that is likely to constrain the market power of airports, Virgin Blue is very concerned by the Commission's willingness to extend the period of price monitoring for another 5 years without any constraint on airports' market power.

The idea that, unless constrained in some way, companies with market power will seek to exploit that power to the detriment of customers and society as a whole is hardly novel.

Indeed, in the Commission's 2002 report on airport price regulation, the Commission stated that:[24]

> "*In essence, a firm with market power (and assuming that price discrimination is not feasible) will restrict the amount supplied and raise the price in order to increase its profits at the expense of consumers. The source of efficiency loss is the reduction in production and consumption of the good or service below the efficient level — the so-called monopoly deadweight loss.*"

In the context of the aviation industry, the Commission then expressed the concern in this way in its 2002 report (having considered the potentially constraining effect of non-aeronautical commercial activities at airports):[25]

> "*Nonetheless, the concern remains that airports with market power will increase aeronautical charges above (efficient) costs, thus increasing airfares and reducing consumption of air travel. Persistently-high airport charges normally would also yield monopoly profits for airports. In these circumstances, price regulation that promoted efficient aeronautical prices could deliver economic gains to the general community — provided such regulation did not create offsetting distortions and costs — and bring benefits to passengers and airlines at the expense of airports.*"

However, in the Draft Report, the Commission appears to believe that monopolists will resist their strong incentives (including their duties to shareholders) to maximise their profits through exploiting their market power. But it should be clear that, unless there is an effective constraint, monopolists will act as monopolists, and in the case of major airports, the Commission can no longer point to any effective constraint. If a monopolist is watched closely, monopoly profits may be achieved more slowly than would otherwise be the case, and the true reasons for increases in prices (or failures to decrease prices) may be masked, but the outcome cannot be in any doubt.

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[24] Productivity Commission, *Price Regulation of Airport Services*, Inquiry Report, 2002 , p 83

[25] Productivity Commission, *Price Regulation of Airport Services*, Inquiry Report, 2002 , p 80

There is no need to wait to observe the outcome when the outcome is certain.

The Draft Report is based on the idea that commercial negotiations between airlines and airports, of the sort that occur in competitive markets, will develop so long as the parties are given sufficient time.

Agreements as a result of "commercial negotiations" appear to be the key goal of light handed regulation. However, consideration must be given to what is meant by the term "commercial negotiations". If what is meant is simply agreements that are entered into by companies following discussions and accepting standard terms, then such agreements currently exist between airports and airlines. However where, as is the case with major airports, one party possesses substantial market power, those agreements are likely to be struck on terms and conditions imposed by the party with substantial market power and such terms and conditions are likely to include prices above efficient levels and have significant adverse consequences for social welfare. There seems little point in pursuing such agreements as an end in themselves.

If, on the other hand, the term "commercial negotiations", refers to the sorts of negotiations that take place in competitive markets, then these negotiations will not occur unless there is effective constraint on the ability of airports to exercise their market power. As noted above, given that the Commission is unable to identify any effective constraint, there is no reason to expect that negotiations of the sort that would occur in a contestable or competitive market will suddenly occur in markets that are neither contestable nor competitive.

4 ANALYSIS OF THE CONDUCT OF AIRPORTS

4.1 The relevant test for assessing airports' conduct

The existing difficulties in determining when an airport may have contravened the Government's Review Principles are compounded by the approach adopted by the Commission in its Draft Report.

The Terms of Reference ask whether airport operators have acted in a manner consistent with the Government's Review Principles. In relation to prices, the key Principle states that:

> "*At airports without significant capacity constraints, efficient prices broadly should generate expected revenue that is not significantly above the long run costs of efficiently providing aeronautical services (on a 'dual-till' basis). Prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.*"

However, in its Draft Report, the Commission does not examine whether airports' prices have generated revenue that is not significantly above the long run costs of efficiently providing aeronautical services.

Instead, the Commission refers repeatedly to a number of different formulations for a different test, relating to the misuse of market power. It is not entirely clear what the Commission is referring to when it uses this term: it has a specific meaning under s 46 of the Trade Practices Act which is not relevant to the Commission's inquiry, and the Tribunal in *Re Virgin Blue Airlines* used the expression in another sense. In any event, having focussed on misuse of market power, the Commission then expresses the test for whether an airport has contravened the Review Principles in a number of ways. For example:

(a) "any *significant* misuse of market power through the setting of prices *substantially* above levels required to meet costs and provide a reasonable rate of return" (p 44);

(b) "evidence of any *systematic* misuse of market power in setting charges" (p 53);

(c) "evidence of *costly* misuse of market power" (p 54); and

(d) "*strong* evidence of *significant* misuse of market power" (p 55).

It is very unclear on the basis of the different tests set out above what conduct by an airport would, in the Commission's view, contravene the Government's Review Principles. Indeed, there is a real question as to whether any conduct by one airport could amount to a contravention of the Review Principles if conduct needs be "systematic" to contravene the Review Principles. Further, the Commission's use of the italicised qualifiers would allow for there to be significant disagreement as to whether any of these tests proposed by the Commission had been met. As discussed above, if there is no clarity as to when sanctions would be imposed, then the threat of re-regulation will not be effective.

4.2 Price changes at airports

The Allen Consulting Group has considered empirical information relating to airports' revenues and costs.[26] In summary, they found that:

(a) there is no basis on which the Commission could find that price and revenue increases since the removal of price control are justified, in fact, increases have been substantially more than could be justified by cost increases or external shocks; and

(b) given that passenger numbers have increased, prices should have decreased, but that has not happened.

[26] The Allen Consulting Group, "Productivity Commission Review of Airport Pricing, Issues arising from the Draft Report", October 2006, chapter 2

Virgin Blue notes that under the terms of its agreements with airports, there is scope for further price increases, without Virgin Blue's consent (see section 4.5 below). In the absence of effective regulation, given airports' market power and observations of price increases since the removal of price controls, Virgin Blue would expect that further price increases will occur.

4.3 Comparisons of airport charges

A Limitations on comparison data

It is a standard principle of economic regulation that the cost of providing an infrastructure service provides an essential marker to the price that would be appropriate. This principle follows from considering the requirements for economic efficiency: preserving the incentive to invest requires the asset owner to expect to be able to recover its costs (including an appropriate return), while maximising allocative efficiency typically requires average prices to be minimised – and these objectives are reconciled by setting average prices with reference to cost. This principle also follows from considering the outcomes of a competitive or contestable market: long run equilibrium attains when entry and exit has occurred until firms earn revenue that just recovers their costs. Indeed, the Commission has accepted throughout the Draft Report that if the Australian airports suffer an increase in the cost, then that would provide a justification for an increase in the prices that are charged – and hence has accepted that the cost incurred in providing airport services will determine what price is charged.

It follows, therefore, that an implicit – but integral – assumption behind the Commission's 'benchmarking' of the *price* that is charged by the major Australian airports to the prices that are charged by airports overseas and the smaller Australian airports is that the *average cost* of providing the relevant airport services is identical across all of the airports that have been compared. As discussed in the previous paragraph, any differences in the average cost providing airport services at the different airports would imply that the price charged should be different and so comparisons of prices charged would be meaningless. Moreover, it would be expected that the average cost incurred in providing airport services would differ substantially across airports, for the following reasons amongst others:

- *Size of the airport* – as the provision of many airport services is characterised by strong economies of scale, the average cost of providing these services would depend on the size of the airport, with very small airports in particular expected to have a higher average cost.[27]

  – For this reason, the prices that are charged by the non-monitored airports cannot be used to infer that the prices charged at the major airports are appropriate – the smaller

[27] This reflects the fact that the decline in average cost would be expected to be particularly pronounced over the range of output prior to duplication of infrastructure being required.

airports would have a higher average cost and hence would be expected to charge higher prices.

- *Prices of inputs* – the average cost of providing airport services will be affected by the prices of key inputs, such as land, the labour and building materials. These prices vary substantially across Australia, and would be expected to have an even greater variation across the international airports.

  – Australia is likely to be a 'cheap' source for land and labour (and probably also building materials) compared to destinations like the US, Europe and Japan, which invalidates price comparisons with airports at these destinations.

- *Level of government support* – airports around the world have a different history in terms of the extent to which governments have publicly funded the infrastructure as opposed to requiring all of the cost of the infrastructure to be recovered through airport charges.

  – The major Australian airports were constructed by the Government, and the prices for airport services prior to privatisation were not fully recovering the sunk cost of providing this infrastructure. The Commission has acknowledged that there is little justification for permitting airport charges to rise to now permit the privatised operators to fully recover the sunk cost of providing the infrastructure they inherited at privatisation (and thereby receive a large windfall gain). Accordingly, it is also meaningless to compare the price that is charged by Australian airports to any airports that have set prices from the start to fully recover the cost of providing the relevant infrastructure.

- *Mix of international versus domestic traffic* – international traffic both imposes higher costs and generates higher revenues compared with domestic traffic.

In short, the Commission's simple comparison of the prices charged by the major Australian airports with airports overseas and elsewhere in Australia cannot be relied upon to provide any meaningful insights. The 'appropriate' price for an airport service is one that reflects the cost of providing that service, and this cost would be expected to vary significantly across airports, which is ignored in the Commission's analysis.

B Comparisons between monitored and non-monitored Australian airports

The Commission compares prices at monitored and non-monitored airports in Australia and finds that they are "not out of line". However, as noted by TRL in its report for Melbourne Airport:[28]

[28] TRL, "Comparison of International Airport Charges", Final Report (Revised), February 2006, p 130

> *"…the high level of fixed costs in airport operations will tend to mean that small airports need to charge more than large airports in order to achieve adequate levels of cost recovery."*

For that reason, it should be expected that the monitored airports' charges will be *lower* than those of the non-monitored airports, which are generally smaller. The Commission recognises this in its discussion surrounding the higher charges at Darwin Airport.

Table 2.3 of the Draft Report shows that domestic charges at Adelaide, Canberra and Perth are higher than at Hobart and Cairns. However, their larger size suggests that they should be lower. Charges at Melbourne, Brisbane and Sydney have not been included in the table, but logic would suggest that they should also be significantly lower than those at the smaller airports, due to their substantial economies of scale.

If the charges at smaller airports are comparable to charges at monitored airports, as the Commission suggests, it is highly likely that the monitored airports are over-recovering their costs.

C Comparisons between Australian and international airports

In addition to the general difficulties associated with international benchmarking of charges, the specific data relied on by the Commission is problematic. The Commission presents two sets of data, both reproduced from studies by TRL.

The first of these, figure 2.2 (Draft Report, p 19), is taken from TRL's report for Melbourne Airport. This data deals only with charges for international services; it does not include data relating to domestic charges. For that reason, no conclusions can be drawn in relation to the monitored airports' domestic charges.

However, figure 2.3 (Draft Report, p 19) does include domestic charges. However, they are aggregated with international charges. Comparisons which aggregate international and domestic charges at airports with entirely different characteristics are meaningless. The graph purports to show that charges at Australian airports are relatively low. However, international charges are generally substantially higher than domestic charges, which TRL acknowledges, stating:[29]

> *"The characteristics of an airport's passengers will have an impact on both its revenues and costs. A high proportion of domestic traffic will tend to reduce both…"*

Major international airports would be expected to report higher charges, especially on a per movement basis, for two reasons:

[29] TRL, "Airport Performance Indicators 2004", p 53

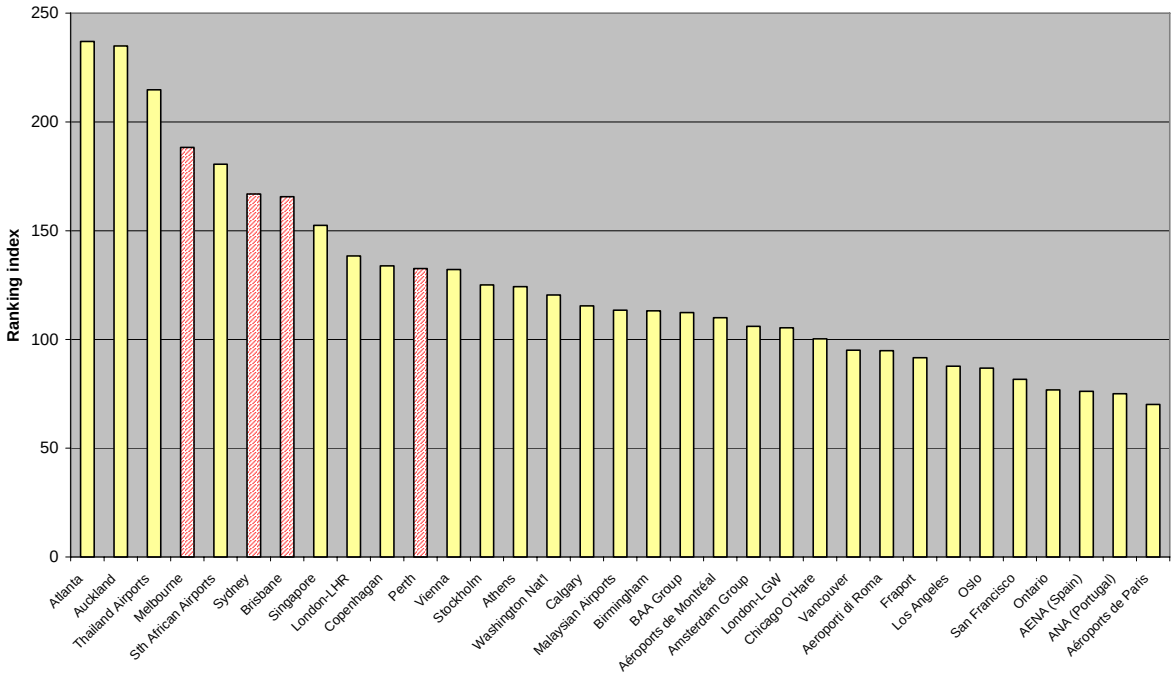
(a) international traffic imposes higher unit costs and therefore generates higher revenues than domestic traffic regardless of whether it is measured on an MTOW or a per passenger basis; and

(b) when measured on a per movement basis, this difference is likely to be further exacerbated by the fact that aircraft used for international flights are likely to be larger on average than aircraft used for domestic flights, and therefore will generate more revenue *per movement* regardless of whether charges are levied on a per passenger or weight basis.

This expectation is borne out in the data presented. It is unsurprising that airports with a large proportion of international traffic, such as Osaka, Narita and Hong Kong, have a high level of aeronautical revenue per air traffic movement. However, it is very surprising that Sydney, Perth, Brisbane and Melbourne airports, with a high proportion of domestic traffic, are in the top 31 airports in the world.

The same TRL report (*Airport Performance Indicators 2004*) includes several other international comparisons. Set out below is the operating profit at a number of international airports. Melbourne, Sydney and Brisbane airports are among the top 10 airports internationally, with Perth at number 11.

Operating Profit at Selected International Airports



Source: TRL Airport Performance Indicators 2004

Virgin Blue therefore considers that it is misleading for international comparisons to be presented to contend that charges in Australia are at or near competitive levels. Apart from the flaws in the

data itself, Australia's operating characteristics, including the lack of alternatives to most airports and relatively large proportion of domestic flights, mean that a more accurate assessment of whether airports are over-recovering their costs must involve an inquiry of the costs and revenues at the airports themselves. As is evident from the work done by Allen Consulting Group, airports are over-recovering their costs.[30]

The Commission states that TRL found that profitability at Australian airports is "broadly comparable with airports in Europe and Canada, and higher than those in the USA".[31] In fact, TRL found that Australian airports are "the most profitable airports in the sample".[32]

4.4 Per passenger charging

In the Draft Report, the Commission refers to 3 arguments to support its conclusion that "*the shift to passenger-based charges is not of itself inconsistent with the Government's Review Principles, nor necessarily inimical to efficiency.*"[33] These 3 arguments are:

(a) both weight-based and passenger-based charging have pluses and minuses for efficiency and that therefore one form is not unequivocally better than the other;

(b) the presumed disadvantage for low cost carriers from the adoption of passenger-based charging because of their higher load factors, is not supported by load factor data; and

(c) Virgin Blue's position on passenger based charges at Sydney Airport is inconsistent with its willingness to accept such charges at some other airports, as part of a wider negotiated package.

Virgin Blue disagrees with the Commission's conclusions, and considers that passenger-based charges for take off and landing are both inconsistent with the Government's Review Principles and inimical to efficiency. Further, Virgin Blue does not consider that any of the arguments cited by the Commission support the Commission's conclusion. Although it is not easy to fully understand the Commission's reasoning because the Draft Report does not contain any detailed analysis from the Commission on this issue, Virgin Blue sets out below its responses to the 3 arguments cited by the Commission.

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30 The Allen Consulting Group, "Productivity Commission Review of Airport Pricing, Issues arising from the Draft Report", October 2006, chapter 2

31 Draft Report, p 21

32 TRL, "Benchmarking International Airport Performance", Final Report, June 2006, p 77

33 Draft Report, p 30

A Both forms of charging have pluses and minuses

Virgin Blue is surprised that the Commission finds that "*it is by no means clear that passenger-based charges are any less efficient than weight based charges*",[34] given the detailed analysis of this issue by the Tribunal in *Re Virgin Blue Airlines*.

At the outset, it should be remembered that Virgin Blue's concern is with passenger based charging for take off and landing charges, not passenger based charges for terminal use. Virgin Blue agrees that per passenger charging for terminal use is appropriate. In this regard, it is worthwhile noting that the first advantage of passenger-based charges listed by Brisbane Airport in its submission to the Commission is "*Direct relationship with the cost of providing terminal facilities*"[35] (emphasis added). In relation to weight based charges, Brisbane Airport states that they have, "*[t]o some extent, stronger relationship with cost of providing runways, taxiways and aprons at the airport.*"[36] The Commission describes Brisbane Airport as taking the middle ground,[37] however it is apparent that, insofar as cost drivers are concerned,[38] Brisbane Airport's submission agrees with Virgin Blue's position because it favours weight based charges for take off and landing and passenger based charges for terminal use.

In *Re Virgin Blue Airlines*, several expert economists gave detailed evidence on the efficiency of passenger based take off and landing charges. The Tribunal, consisting of a Federal Court judge, an economist and a lay member found that:[39]

> *"…we reject SACL's submissions that the Domestic PSC encourages a more efficient use of Sydney Airport than does an MTOW-based charge. Efficient pricing of the charges for the Airside Service would require consideration of the cost drivers underlying the provision of those services by reference to the aircraft using those facilities, rather than by reference to the number of passengers travelling in such aircraft. Considerations of capacity or slot constraints at Sydney Airport are not a relevant consideration in the short to medium term and do not, in any event, alter our conclusion that a passenger-based charge in the form presently adopted by SACL does not present a more efficient form of pricing than an MTOW-based charge, nor encourage more efficient use of the Airside Service provided at Sydney Airport."*

Virgin Blue also made detailed submissions to the Commission in relation to the inefficiencies arising from per passenger pricing.[40] Virgin Blue is disappointed that the Commission does not

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34 Draft Report, p 165

35 Brisbane Airport submission (No 35) p 28

36 Brisbane Airport submission (No 35) p 28

37 Draft Report, p 166

38 Apart from cost drivers, the other advantages and disadvantages of passenger based and weight based charging listed in Brisbane Airport's submission were all addressed by the Tribunal in *Re Virgin Blue Airlines*.

39 *Re Virgin Blue Airlines*, paragraph [245]

40 Virgin Blue submission, 18 August 2006, pp 13-23

appear to have engaged with Virgin Blue's submissions, including Virgin Blue's rebuttal of Melbourne Airport's arguments in its submission dated 18 August 2006. Instead, the Draft Report merely refers to that submission without further analysis.[41] Further, the Commission does not appear to have responded to the efficiency arguments set out in detail in the presentation *The impact of low fare airlines on private sector airports* by Kerrie Mather, CEO of Macquarie Airports.

There is no credible efficiency argument in favour of passenger based charges for take off and landing that emerges from any of the material presented to the Commission. The only efficiency arguments in favour of passenger based charges referred to by the Commission are those advanced by Melbourne Airport in its submission, being:

(a) passenger based charges are a better proxy for runway damage than weight based charges;[42] and

(b) a pricing structure that encourages larger planes would promote a more efficient use of resources.

Neither of these arguments withstand any detailed consideration for the reasons set out in Virgin Blue's supplementary submission to the Commission dated 18 August 2006.

The Commission also discounts the significance of the relatively greater impact a change from a weight-based to a passenger-based charge will have on an LCC as compared to an FSA. The Commission acknowledges that the effect of those charges may have a different impact on different airlines, but does not accept that a change from weight-based to per passenger charges could be construed as "a misuse of market power" (whatever this may be) unless the differential impact is part of a deliberate strategy to disadvantage one airline in pursuit of monopoly rent. While the Tribunal in *Re Virgin Blue Airlines* did find positively that SACL's conduct was part of deliberate strategy to disadvantage Virgin Blue, Virgin Blue is very troubled by this statement from the Commission. First, as discussed above, the Commission appears to believe that the Terms of Reference require it to find that airports have engaged in a misuse of market power, but this is not at all what the Terms of Reference require. The Terms of Reference refer to the Government's Review Principles, which in turn refer to whether revenues from aeronautical charges exceed efficient costs – they do not refer to "misuse of market power". Further, without explaining at any point what it means by "misuse of market power", the Commission proceeds to

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41 Draft Report, p 166

42 The Commission may be aware of work that has been done in relation to overseas airports to determine the best way to charge for runway use according to damage caused by different aircraft: see for example *Calculating the Short-Run Marginal Infrastructure Costs of Runway Use: An Application to Dublin Airport* by O Hogan and D Starkie in Forsyth et al (eds), *The Economic Regulation of Airports* at p 75. This work argues that in determining runway damage, MTOW is only one factor and recommends a weighted charge per tonne depending on the damage caused by the relevant class of aircraft. While some may argue that this work demonstrates that MTOW charges are not a good proxy for runway charges, Virgin Blue notes that: this work recognises that MTOW is still a factor in runway damage and does not refer to passenger based charges at all (which would not have any direct relationship to runway damage); and also that runway damage is not the only reason why airports internationally adopt MTOW charges.

opine on what is not, in its view, a misuse of market power. Obviously if the Commission has not explained what it considers to be a misuse of market power, it is very difficult for Virgin Blue to comment on what the Commission considers not to be a misuse of market power.

The important point for the Commission's inquiry is that per passenger charges for take off and landing have significant impacts on:

(a) airline and airport efficiency; and

(b) competition in the dependent airline industry,

both of which have substantial adverse consequences for social welfare.

Considering the impact on competition of passenger based charges, Dr Philip Williams, an independent expert giving evidence to the Tribunal on behalf of Virgin Blue, stated that the change from weight-based to passenger-based charges:[43]

> *"…is likely to have differential effects on full-service airlines compared with low-cost airlines. In particular, it is likely to cause low-cost airlines to increase their prices by a larger proportion than will be the case for full service airlines; and it is likely to have a bigger (proportional) impact on the profits of the former type of airline than it will on the latter type.*
>
> *A second effect is perhaps more worrying from the point of view of effect on competition. This is that a transfer of costs from costs that are invariant with respect to the number of passengers to those that vary with the number of passengers is likely to soften competition in the dependent market. This proposition comes from the standard models by which economists analyse strategic interactions among enterprises. "*

The Tribunal agreed with Dr Philip Williams' analysis, and stated that:[44]

> *"Dr Williams explained, and we accept, that the change from an MTOW-based charge to the Domestic PSC has the effect of changing the ratio of fixed costs to variable costs for the airlines. When SACL changed the tariff structure, the cost that was formerly fixed (with respect to the number of passengers on the aircraft) was converted to a cost that varied according to the number of passengers on the aircraft. The ratio of fixed to variable costs is one of the basic conditions that affects competition in the dependent market.*
>
> *This conversion of a fixed cost to a variable cost has two significant consequences for competition in the dependent market. First, FSAs are favoured over LCCs as the tariff*

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43 Frontier Economics, "Application for Declaration of the Airside Service at Sydney Airport", 12 August 2004, paragraphs [209]-[211]

44 at paragraphs [523]-[525]

structure has a differential impact on LCCs as compared to FSAs. LCCs will have to increase their prices by a larger proportionate amount than FSAs to accommodate the change to the passenger-based charge. To the extent that LCCs are constrained in the price they can set for airfares, this would be expected to lead to a larger proportional impact on the profits of LCCs.

The second consequence of the change in the fixed to variable cost ratio identified by Dr Williams is that airlines are less likely to chase incremental or marginal customers and less likely to be concerned about losing marginal customers to their rivals. If a competitor were successfully to attract passengers away from another airline, the higher the costs that the airline will save by losing those marginal passengers to its competitor, the less its incentive to respond to the competitor's activities. Dr Williams explained this as a "softening" of competition. We accept that this is a likely consequence."

That reasoning explains two propositions not accepted by the Commission:

(a) that a move from weight-based to passenger-based charges has a greater impact on an LCC than on a FSA; and

(b) that a move from weight-based to passenger-based charges will have a negative impact on competition.

It must be noted that these arguments are based on general economic propositions; they are not specific to Sydney Airport, and the Commission should not disregard them on that basis.

We attach to this submission a copy of the report that was prepared by Dr Williams and provided to the Tribunal in *Re Virgin Blue Airlines* so that the Commission can fully consider the relevant reasoning.

Dr Williams' analysis is supported by a recent article by in the Journal of Transport Economics and Policy, *An Analysis of Airport Pricing and Regulation in the Presence of Competition Between Full Service Airlines and Low Cost Carriers*. In that article, the authors, Fu, Lijesen and Oum, found that:[45]

"…an identical input price increase will proportionally harm the LCC more. Although such an identical input price increase, such as a per-passenger airport service charge of a government imposed per-passenger security charge, is likely to constitute only a small proportion of the total unit costs, its impacts may be non-trivial."

[45] Xiaowen Fu, Mark Lijesen and Tae H. Oum, "An Analysis of Airport Pricing and Regulation in the Presence of Competition Between Full Service Airlines and Low Cost Carriers", *Journal of Transport Economics and Policy*, Volume 40, Part 3, September 2006, pp 425-447, p 437 (footnotes omitted).

They went on to state that:[46]

> *"The level of an airport's user charge affects not only air travel demand and social welfare, but also competition in the downstream airline markets to/from that airport. This latter aspect of the effect of airport user charges has been overlooked and thus has not been incorporated in the analysis of airport pricing and regulation.*
>
> …
>
> *When two airlines compete with differentiated products, such as the case where an FSA and an LCC compete with each other, the LCC will lose its output and profits proportionally more that its FSA competitor. As a result, such an increase in airport user charges would harm competition in the downstream airline markets to and from that airport."*

On that basis, it is difficult to see how the Commission can continue to hold the view that there are efficiencies associated with both per passenger and weight-based charges, and that per passenger charges are not of themselves inimical to efficiency given their impact on competition.

In its Draft Report, the Commission refers at p 167 to the submission from the National Competition Council (**Council**) stating:

> "*Also, the NCC (sub. 5 p. 4) contended that while LCCs do rely on more heavily on the price sensitive part of the market than FSAs, it is not clear that they have less capacity than FSAs to absorb a price increase, or to price discriminate so as to minimise impacts on demand.*"

In the passage to which the Commission refers, the Council was quoting from its 2003 Final Decision in relation to Virgin Blue's application for a recommendation that the Airside Service at Sydney Airport be declared. Further, in that decision, the Council stated only that it was not clear that low cost carriers had less capacity to absorb a price increase or price discriminate compared with full service airlines. Given that this 2003 Final Decision predates the Tribunal's decision and the work of Dr Williams and of Fu, Lijesen and Oum, little can be gained from the fact that, at that earlier point of time, the Council was unsure of the relevant capacities of LCCs compared with FSAs.

In any event, the subsequent work of Dr Williams and of Fu, Lijesen and Oum (and the Tribunal's decision) demonstrates that the impact of per passenger charges and increased charges is more significant for low cost carriers compared with full service airlines.

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[46] op cit Fu et al, p 443

In addition, weight-based, as opposed to passenger-based, charges for the use of runways, taxiways and aprons are international best practice. The International Civil Aviation Organisation (**ICAO**) has published policies on charges for airports and air navigation services.

ICAO recommends that:[47]

> *"Landing charges should be based on the weight formula, using the maximum permissible take-off weight as indicated in the certificate of air worthiness (or other prescribed document) as the basis for assessment. However, allowance should be made for the use of a fixed charge per aircraft or a combination of a fixed charge with a weight-related element, in certain circumstances, such as at congested airports and during peak periods."*

As Virgin Blue noted in its earlier submission, only airports in Australia and New Zealand have adopted per passenger charging for take off and landing. These airports have in common the highly unusual combination of private operation with only light handed regulation (if any). Given the Commission's interest in international comparisons when considering the level of airport charges, Virgin Blue considers that the position internationally with respect to the structure of take off and landing charges should be compelling.

In summary, it is misguided for the Commission to contend that per passenger charging for take off and landing fees has both pluses and minuses. Weight-based charges are more efficient, promote consumer welfare and are international best practice.

B Load factor data

The second reason advanced by the Comission to support its draft finding that passenger based charging is not contrary to the Government's Review Principles nor inimical to efficiency is that the presumed disadvantage for low cost carriers from the adoption of passenger-based charging because of their higher load factors is not supported by load factor data.

Virgin Blue has two strong objections to this argument: first, it misrepresents the argument put forward by Virgin Blue, and secondly even if the argument did relate solely to load factors, it misrepresents the load factor data.

In relation to the first objection, Virgin Blue's argument that low cost carriers are disdavantaged by passenger based charges relates to the fact that low cost carriers carry more people than full service airlines for the same type (and weight) of plane, and does not simply relate to load factors. The number of people carried on a plane is a function of both the number of seats on that plane and the load factor for that flight. As explained in its submission to the Commission dated

[47] ICAO's Policies on Charges for Airports and Air Navigation Services, 6th edition 2001, 7th edition 2004 at p 9

18 August 2006, Virgin Blue has 180 seats on its Boeing 737-800 aircraft compared with Qantas which only has 168 seats on its Boeing 737-800s.[48] Therefore with an 80% load factor, Virgin Blue would carry 144 passengers on its aircraft while Qantas would only carry 134 passengers on its aircraft. For the same reason, if both Qantas and Virgin Blue carried 140 passengers on their Boeing 737-800 aircraft, Qantas would have a load factor of 83%, whereas Virgin Blue would have a lower load factor of 77%. Virgin Blue is disadvantaged because on average it carries more passengers than Qantas for a given weight of aircraft, whether this be because of higher load factors or because its aircraft have more seats on them than Qantas' aircraft.

However, even if its argument did rely solely on load factors, Virgin Blue would still object to the Productivity Commission's conclusion that the argument was not supported by the load factor data. Due in part to the absence of detailed analysis in the Draft Report, it is not clear what basis the Commission had for this assertion, apart from the statement on p 167 of the Draft Report that "*… Melbourne Airport (sub. 13, p 65) said that Virgin Blue's load factors have been consistently lower than Qantas' domestic operations*." Melbourne Airport's submission refers at p 65 to load factor data for only the month of April 2006 and states that: "*[t]hese data show that Virgin Blue in fact has a lower load factor than Qantas*." Melbourne Airport goes on to state (without any further analysis) that "*Melbourne Airport does not believe that this month is an isolated case.*"

Load factor data showing the performance of the Qantas Group against Virgin Blue and Pacific Blue is publicly available.[49] That data for the period from July 2005 to June 2006 is as follows:[50]

Table 3.1 Load Factors: Combined Domestic and International July 2005 to June 2006

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Qantas Group	79%	75%	78%	77%	77%	-	80%	76%	75%	78%	72%	-
Virgin and Pacific Blue	82%	78%	81%	80%	79%	79%	81%	76%	75%	77%	72%	74%
Higher Load factor	VB/ PB	VB/ PB	VB/ PB	VB/ PB	VB/ PB		VB/ PB	VB/ PB	VB/ PB	QG	VB/ PB	

source: ASX announcements from Qantas and Virgin Blue

The above table shows that, on the available data, there was only one month in the 12 month period where the load factor for the Qantas Group exceeded the load factor for Virgin Blue and

48 Virgin Blue, submission dated 18 August 2006, p 22

49 Virgin Blue notes that all of the load factor figures referred to in this submission are *revenue* load factor figures (ie revenue seat kilometres divided by available seat kilometres) and are therefore weighted according to the distance travelled rather than simply an average per flight. Virgin Blue has used this data because it is the publicly available load factor data, and Virgin Blue notes that Melbourne Airport in its submission also used revenue load factor data.

50 Virgin Blue notes that Qantas does not publish monthly data for the months of June and December in any given year as the figures it publishes in those months are full year or year to date totals.

Pacific Blue – April 2006. In all other months, the load factor for Virgin Blue and Pacific Blue exceeded the load factor for the Qantas Group.

[**CONFIDENTIAL**][51] [52]

Virgin Blue is concerned that Melbourne Airport would make a claim such as the one that it did in relation to load factors on the basis of one month's data without checking other months in that

[51] [**CONFIDENTIAL**]

[52] [**CONFIDENTIAL**]

financial year. Virgin Blue is struck by the coincidence that the only month that Melbourne Airport presented to the Commission was the one month in which, on a like for like basis, Qantas' load factors exceeded those of Virgin Blue. April 2006 is an odd month to choose at random for a comparison if only one month is going to be chosen.

More than that, however, Virgin Blue is concerned that the Commission appears to have accepted the assertion of Melbourne Airport on the question of load factors without checking the basis for that assertion. Load factor data for each of the Qantas entities and for Virgin Blue and Pacific Blue combined is publicly available, and as noted above, a check of this publicly available data would have indicated that April 2006 was by no means a typical month, and that Melbourne Airport's assertion is incorrect. We attach for the Commission's reference the public announcements that Virgin Blue has used to obtain the public revenue load factor data referred to in this submission.

In conclusion, the disadvantage suffered by low cost carriers stems from the fact they carry more passengers than full service airlines for the same type (and weight) of plane, which is not due solely to load factors.

[**CONFIDENTIAL**]

C Virgin Blue has accepted passenger based charges at other airports

The final basis on which the Commission has concluded that per passenger charges are not necessarily problematic is that Virgin Blue has accepted them at certain airports where they formed part of a larger, negotiated package. However, this reasoning fails to recognise the lack of bargaining power that Virgin Blue has when negotiating with monopoly airports. Despite suggestions by the Commission, Virgin Blue has not "accepted" per passenger charges as part of any genuine negotiation, rather Virgin Blue has been presented with those charges by airports and has had no choice but to agree in order to be able to offer services to and from particular destinations.

NT Airports, in its submission to the Commission (at p 10), says that Virgin Blue "welcomed" per passenger charges. This is simply incorrect, and there is no basis that Virgin Blue is aware of on which NT Airports could make such an assertion. Per passenger charging was introduced at Darwin Airport before Virgin Blue commenced operating to that airport, and when Virgin Blue did commence operating, it was unable to have the basis changed. Further, in subsequent discussions with Darwin Airport in relation to aeronautical charges, Virgin Blue has stated its objections to per passenger charges and requested (so far) unsuccessfully that Darwin Airport revert to weight based charges.

The Commission also misrepresents Virgin Blue's own description of its "negotiation" with airports, stating in support of its argument that per passenger charges *per se* are not the issue:

> *"This is reinforced by Virgin Blue's statement to the Tribunal that it had accepted passenger-based charges at other airports as part of a wider negotiated package involving beneficial offsets to this form of charging (ACT 2005, para. 189).."*

In fact, the passage of the Tribunal's decision cited by the Commission quotes a letter from Virgin Blue to SACL during the course of commercial negotiations in which Virgin Blue stated that it had:

> *"…reluctantly accepted passenger-based charges at other airports, but these charges were part of wider deals with these airports that on balance allowed Virgin Blue to maintain its competitive position."*

In that context, the statement cannot be seen as an endorsement of per passenger pricing. Rather, it reflects Virgin Blue's limited bargaining power and need to try to negotiate other elements of a deal where an airport is insisting on per passenger charges. [**CONFIDENTIAL**]

To justify the conduct of a monopoly airport on the basis that the airline continued to fly to the airport (and therefore accepted the conduct) would justify any abuse of market power by the airport short of an actual or constructive refusal to deal. On this basis, Virgin Blue could be said to have "accepted" passenger based charges at all airports where they have been imposed and where Virgin Blue continues to fly (including Sydney Airport). However, this is not to say that per passenger charges were introduced through any truly commercial negotiation between Virgin Blue and the airport of the sort that would occur in a competitive market.

D Conclusion re per passenger charges

For the reasons set out above and its previous submissions to the Commission, Virgin Blue considers that in its final report, the Commission should make a positive finding that per passenger charges for take off and landing:

(a) are inefficient;

(b) have a negative impact on competition in the dependent airline industry; and

(c) are contrary to internationally accepted best practice.

4.5 Virgin Blue's agreements with airports

In the Draft Report, the Commission proceeds on the premise that all agreements between airlines and airports contain fixed charges for aeronautical services for the life of the agreement. For example, the Commission states that:

"*Moreover, concerns from some airlines that current charges are 'over-recovering' at least partly reflect stronger demand growth than was anticipated when those charges were struck. In the absence of provision in contracts for frequent adjustments to charges to reflect such unanticipated demand growth, realised rates of return may well be higher than was intended at the time base charges were agreed. But this is essentially an issue for the next round of price contracts. Presumably for this reason, many of the airlines' concerns about pricing relate to proposed charges once current contracts expire, rather than to the charges now in place.*" (p 25)

However, many airports expressly reserve the right to vary aeronautical charges during the term of their agreements. For example, SACL's Conditions of Use state:

"*8.1 Subject to this clause, we may vary any of the charges or the application of them at any time by giving you 30 days notice in writing of a proposed maximum increase in charges or application before the variation becomes effective.*

…

8.2 We will consult with you (either directly or through relevant industry bodies) at least 90 days before varying charges."

Interestingly, SACL's Conditions of Use appear to only contemplate a variation that amounts to an increase in charges rather than a decrease – but this merely reflects the attitude of the drafter of the document, being SACL.

Virgin Blue does not have a signed agreement with Perth Airport. However, Perth Airport publishes its standard terms and conditions, called the Prices and Services Accord. While that Accord provides for the charges that are to be imposed on airlines, and the manner in which those charges can be changed, there are further overarching provisions in relation to amendments to the Accord itself. Clause 8.3 of the Accord provides that:

"*[Westralia Airports Corporation] will provide 90 days notice of any proposed changes to the provisions of the Accord. Airline Operators will also be consulted in relation to any such proposed changes.*"

It would appear that that clause provides Perth Airport with the ability to increase charges unilaterally with 90 days' notice. While consultation is required, there is no requirement that agreement be reached, nor parameters around what would constitute consultation for the purposes of the Accord. For that reason, it is highly unlikely that the consultation requirement would result in meaningful discussions between the airport and airlines.

Virgin Blue also does not have a signed agreement with Adelaide Airport. In those circumstances, Virgin Blue clearly faces the risk that Adelaide Airport will increase its charges to Virgin Blue.

However, regardless of the form of the standard agreements drafted by airports, as a matter of law, all agreements may be varied with the agreement of the relevant parties, and if an airport was to approach an airline seeking a reduction in charges there would be no reason for an airline not to consent to any necessary variation to the airport's standard agreement.

The fact that the aeronautical charges of many airports can be varied (either upwards or downwards) during their term has two implications for the Commission's consideration of the regulation of airport charges:

(a) first, any argument that charges are only high now because passenger growth has been higher than expected and there is little that airports can do about it because they are contractually "locked in" to the higher rates does not withstand serious scrutiny; and

(b) secondly, any argument that there is less need for annual monitoring of prices is misplaced because airports can, and have, significantly increased charges (or made significant changes to the basis on which they are levied) during the terms of their standard agreements with airlines.

On a separate matter, Virgin Blue is concerned by the comments in the Draft Report that suggest airports routinely offer rebates or incentives of any significance to airlines (see for example Draft Report, pp 29 and 59). In Virgin Blue's experience, apart from isolated cases of volume rebates, price monitored airports do not offer it any significant incentives to encourage it to use their facilities. Some airports have suggested this is at the insistence of airlines and airline organisations. For example the Commission quotes Melbourne Airport stating:

> "*Airlines have historically resisted airport efforts to price discriminate and indeed, certain ICAO conventions prohibit airport price discrimination that favours home international carriers over foreign carriers, irrespective of whether such conduct is efficient.*"

The concern that Melbourne Airport raises in this passage relates to international airlines. They would not prevent incentives being offered to domestic airlines.

4.6 Rates of return

A key input into aeronautical charges will be the appropriate weighted average cost of capital (**WACC**) to apply to airports' assets in calculating airports' return on capital. This is a complex issue, and one that was not canvassed at length by many of the submissions made to the Commission. This was due in part to the complexity of the issue and the fact that, on the negotiate arbitrate model proposed by many parties, such issues would be either agreed by the parties or decided by an arbitrator.

Further, Virgin Blue recommended that improvements to price monitoring would include giving the ACCC an ability to issue parties with detailed guidance on matters such as appropriate rates of return for capital.

Given the complexity of the issues concerned, Virgin Blue is disappointed that the Commission has made a broad statement that "*the risks associated with the operation of major airports in Australia are now higher than in the past*" (p 99) even though the Commission has not recommended that the ACCC, the regulator with significant experience in this area, be allowed to provide guidance on this issue. The Commission even goes on to state that:

> "*To the extent that short term variability in passenger numbers has increased, the pursuit by airports of rates or return somewhat above the benchmarks set by the ACCC five or more years ago would not necessarily be a cause for concern.*"

Virgin Blue disagrees strongly with the Commission's view on this issue, and does not consider that the Commission has given sufficient consideration to the rate of return question to make such a broad pronouncement. Indeed, Virgin Blue notes that the Commission only devotes just over a page of its Draft Report to this very important issue.

In circumstances where Australian airports have been identified as the most profitable in the world (according to a report produced by a consultant retained by an airport),[53] possess substantial market power and are not subject to any effective constraint, Virgin Blue is very surprised that the Commission would not be concerned by airports pursuing a "somewhat" higher rate of return.

Virgin Blue is very concerned that this statement by the Commission, if retained in its final report, will lead to very substantial disagreements between airports and airlines over pricing levels. Airports will seize on the Commission's use of the word "somewhat" to impose prices that are even further above efficient levels than they currently are.

Virgin Blue's concerns are supported by empirical analysis conducted by the Allen Consulting Group, which shows that:[54]

(a) there are no sound qualitative reasons for the asset beta of airports to have risen as a consequence of either the events of 11 September 2001 or the change in airline market structure and the emergence of LCCs. Therefore the proposition that the volatility of airport returns has increased (which is not sufficient for beta risk to have increased) is not supported by the evidence;

(b) the other qualitative arguments advanced by the Commission – such as a change to the structure of the airline industry – are open to alternative hypotheses (namely, that the increase in competition between airlines has raised the market power of airports and reduced their risk); and

(c) there is no basis for assuming that asset betas preciously applied to airports by the ACCC were understated, in fact, the reverse is more likely.

Virgin Blue strongly submits that section 6.4 of the Draft Report should be removed from any final report. Further, Virgin Blue considers that the Commission should recommend that the ACCC issue industry guidelines on acceptable rates of return for airports (see p 74 of Virgin Blue's submission dated 21 July 2006).

5 PRODUCTIVITY IMPLICATIONS FOR PRICES

5.1 The relevance of productivity measures

The Commission refers at several points to high levels of productivity at Australian airports. While Virgin Blue agrees that efficiency is desirable, high productivity does not necessarily mean that airports are not making monopoly rents, and hence creating welfare losses.

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53 See TRL Report June 2006, Melbourne Airport submission (No 13), p 77

54 The Allen Consulting Group, "Productivity Commission Review of Airport Pricing, Issues arising from the Draft Report", October 2006, chapter 4

Virgin Blue submits that when examining airports' efficiency, it is relevant to analyse:

(a) to what extent the efficiencies are reflected in airports' charges, or whether they simply increase the margin between costs and revenues; and

(b) to what extent efficiencies have been achieved through the effort of the airports, which is discussed further below.

5.2 Sharing the benefits of improved productivity

The Commission has proposed that an additional principle be included in the Government Review Principles to the effect that:[55]

> *"the benefits of improved productivity at the price monitored airports should be shared between airport operators and their customers"*

It is accepted that it is important for infrastructure providers to be provided with financial incentives to be efficient in the provision of the relevant services, whether this implies an improvement in efficiency or remaining efficient over time. Permitting infrastructure providers to retain a share of the benefits they create through their initiatives and, symmetrically, bearing a share of the dis-benefits created by a lapse in attention to cost containment and other decision making, are a possible means of providing such incentives.

However, a principle that refers to improved productivity would permit airport owners to retain the 'benefits' that would arise irrespective of any actions of initiatives of the airports, and hence merely deliver windfall gains in circumstances where passenger numbers are growing rapidly.

In particular, as there is spare capacity at Australian airports at the present time, the measured productivity of airports is likely to increase substantially merely as a result of the number of flights and passengers increasing (ie because the increase in usage will not require a commensurate increase in inputs). This growth in the usage of airports is attributable to the efforts of the airlines, and has little to do with the efforts of the airports. For that reason, any cost reductions attributable to increased passenger numbers should be passed through to customers in their entirety. The Commission implicitly recognises this when it states that increased passenger numbers should exert "downward pressure" on prices. Moreover, a second factor that is commonly a source of productivity growth is the adoption of improved technology as assets are replaced or new investment is made. However, again, this source of productivity growth is not attributable to any effort or initiative on the part of the airports, but rather merely from making use of the new technologies that are made available by the efforts of others. Only the last of the potential sources of productivity improvements – namely, the improvement in the technical

[55] Draft Recommendation 5.5.

efficiency of the airports – properly can be attributed to the efforts of the airports and deserves to be rewarded.

The Commission's suggested review principle would only require the benefits of improved productivity to be "shared". However, it is not clear how the Commission envisages that the benefits should be shared or apportioned. For example, an airport could be said to have "shared" the benefit of a cost reduction if it passes through 1% of the value of that reduction and retains 99%. This is unlikely to be "an appropriate sharing" as contemplated by the Commission in its Draft Report. For that reason, any principle requiring that sharing of efficiency gains requires more guidance as to how the benefits are to be allocated or it will be open to airports to use their market power to simply retain the vast majority of any benefit.

There is also a potential contradiction contained in the Commission's Draft Report insofar as the Commission both indicates that:

(a) without new investment, constant charges in the face of strong passenger growth might be indicative of the exercise of market power (p 84); and

(b) airports should be able to "share" the benefits of productivity gains with their customers (p 82).

Given that the Commission does not distinguish in its Draft Report between productivity gains resulting from passenger growth and productivity gains as a result of airports' efforts, airports will simply rely on the second of these statements in order to retain all but a small share of any increased profitability resulting from passenger growth.

It is noted for completeness that the proposal contained here is consistent with the operation of a 'CPI-X' approach to regulation (i.e. where the 'X factor' is set with reference to productivity trends). Under this approach to regulation, it is common to set the 'X factor' with reference to expected industry-wide productivity growth (which in turn is typically estimated with reference to observed productivity growth). By setting the trajectory of prices in this manner, it would be expected that *all* of the expected productivity growth arising from capacity utilisation (scale effects) and the adoption of technical change would be passed through to users in the form of lower prices. Only productivity growth that arises from management initiatives would be expected to accrue to the service provider.

6 INVESTMENT INCENTIVES

The Commission has concluded that one of the major benefits of the new monitoring regime is that the process for 'approving' new investments has improved compared to the previous price

control regime, with the Commission drawing particular comfort from the fact that a regulator could no longer get between a 'willing buyer and willing seller' of the services.[56]

However, the comfort the Commission has drawn from the process for approving new investment under the monitoring regime is overstated. The Commission has only compared the process for investment approval under the price monitoring regime with the process that existed under the previous regime. It has failed to take account of the fact that the process for approving new investment under the previous regime is only one possible means of approving new investment under a price control regime, and one which incorporated an unusual and cumbersome process for that approval. In short, the Commission's concerns with the approval of new investment could have been alleviated by changing the process for approving new investment to place greater reliance on the asset provider and users negotiating over new requirements and commensurably less reliance on the regulator being involved.

The box below describes the process for approving investment in several other regimes where price control is imposed.

Victorian electricity distribution – use of incentive regulation

Under the regulatory arrangements for the Victorian electricity distributors, the distributors are provided with a share of the benefits that are generated from improving the reliability of supply to customers and also incur a share of the cost associated with providing that service improvement. In this way, the distributors are provided with a financial incentive to invest in a manner consistent with providing an optimal level of reliability, and the regulator does not have any formal role in approving whether service improvement projects proceed – rather, the financial incentives are relied upon to deliver optimal investment.

The designs of the service incentive arrangements for the Victorian electricity distributors have taken account of a number of important characteristics of the electricity distribution industry. The most important such feature is that the customers of distribution networks are numerous and diverse customers, which makes it impracticable for customers to be expected to signal directly to the distributors how much they 'benefit' from service improvements (e.g. through negotiation and choice over whether new projects should proceed). Instead the value that customers would be expected to tell the distributor that they place upon service levels is converted into 'financial benefit' to the distributors and incorporated into the price control mechanism.[57]

[56] On p 34 of the Draft Report, the Commission refers to the fact that the ACCC had, on occasion, overturned investment agreements reached between airports and their customers.

[57] This benefit from reliability improvement is typically estimated from surveys that attempt to assess the loss that customers suffer when deprived of electricity supply.

Electricity transmission in Australia

The application of 'incentive regulation' to encourage transmission network service providers (**TNSPs**) has not been feasible, given the difficulty of defining and measuring the full range of benefits that are provided by a transmission network. Instead, the TNSPs are obliged under the relevant regulatory instruments to conduct a cost-benefit test of major augmentation proposals, and to consult with interest stakeholders as part of this process. A dispute resolution process exists for interested parties to challenge the results of the cost-benefit assessment of an augmentation proposal, with the Australian Energy Regulator (**AER**) performing the dispute resolution role. However, putting aside a challenge from landowners where a project was proposed to be constructed (who now are precluded from using this process to challenge a proposal), there have been no disputes since the introduction of the new test in 2002.

The design of the augmentation approval framework for electricity transmission again reflects a key feature of the industry, which is that there are numerous users of the shared transmission network. This precludes direct negotiation between the TNSPs and the users of the network over whether new projects and requires instead for the benefits to all users to be estimated by the TNSP and reflected in its evaluation of a new project.

Monopoly assets with few, well-informed users

Where there are only a few users of a piece of monopoly infrastructure who are well-informed, it is feasible for users to have a formal role in deciding whether new projects should proceed. Users are in the best position to determine the benefits that are likely to flow from a particular project, and hence – when informed of the cost of the project, would be expected to choose for a project to proceed whenever it was efficient to do so. The role of the regulator in this situation would be limited to ensuring that the price implications of any project are known (i.e. settling the issue of how the project would affect the regulatory asset value and also providing guidance about the returns on investment that are considered appropriate) and possibly also protecting any small players from possible strategic behaviour by the larger users.

The process set out above – whereby users decide whether new projects should proceed within the context of a price control regime – is essentially the process that is employed by the Civil Aviation Authority in the UK (referred to as its policy of 'constructive engagement') and for the privatised airports in the US, that were summarised by the Commission in its Draft Report.[58]

[58] Draft Report, p.45

Further, in considering the issue of new investment, the Commission should compare the position under the current price monitoring regime with the position that would exist under the negotiate arbitrate model advocated in a number of submissions to the Commission (including those from the Department of Transport and Regional Services, Melbourne Airport, Virgin Blue, Rex and Qantas). Comparing the position of new investment under the current regime with the position that obtained under the former price control regime creates a misleading impression of the benefits attributable to the current price monitoring regime.

Under a negotiate arbitrate model of the sort proposed by Virgin Blue, there would be no regulator that could get between a willing buyer and a willing seller because neither would invoke the arbitration process. There is no reason to believe that under a negotiate arbitrate model efficient investment by airports would be deterred. In this sense, what is described by the Commission as "*[p]erhaps the most important benefit of the move to light handed prices oversight*"[59] would also be present in a negotiate arbitrate model of the sort proposed by Virgin Blue and many others.

Further, in its consideration of new investment, the Commission refers only to the benefits of unrestricted investment by airports, the Commission does not consider the potential costs of having no effective constraints on investment. These costs may well be significant in circumstances where infrastructure providers with substantial market power are able to earn attractive returns on investment through higher charges to customers. Such an environment creates a strong incentive for airports to over-invest because, unlike the position of an investor in a competitive market, the airport can always earn an attractive rate of return on its investment regardless of whether or not it is efficient.

In this regard, Virgin Blue refers to the Commission's broad statement that:

> "*No major airport user expressed any fundamental problems with actual investment to date, or its timing, at any of the price monitored airports.*" (p 35)

Virgin Blue has had a number of disagreements with airports (including Brisbane and Sydney Airports) in relation to how the cost of investments will be recovered from airlines. In particular, under the current price monitoring regime airports have every incentive to over-recover the cost of investments. This is done in a number of ways, but one of Virgin Blue's current concerns is that airports will invest in infrastructure to cater for increasing passenger numbers, but do not take into account the effect of increased passenger numbers on the existing charges when calculating the increase in charges for the new investment.

Under the current regime, legitimate objections by airlines to investment decisions by airports (including objections relating to how an airport will recover the cost of an investment) can be

[59] Draft Report, p 34

ignored by airports and there is no effective constraint to prevent inefficient investment. However, under a negotiate arbitrate model, there will be an incentive for both airline and airports to genuinely agree on investment decisions and this should act as a constraint on inefficient investment.

In conclusion, on the question of new investment, a negotiate arbitrate model of the sort proposed by numerous parties in their submissions to the Commission would be preferable to the current price monitoring regime because it would deliver the benefits of ensuring efficient investment proceeds in a timely manner while also providing a constraint to prevent wasteful investment (something which the current regime wholly fails to do).

7 ASSET VALUATION

Virgin Blue considers that asset valuation is a key part of any consideration of whether or not airports pricing conduct complies with the Review Principles, especially given that the Review Principles require that aeronautical revenue not be significantly above the long run costs of providing aeronautical services and that prices should allow a return on (appropriately defined and valued) assets (including land) commensurate with the regulatory and commercial risks involved.

Virgin Blue commends the Commission's recommendation that further asset revaluations should not provide a basis for higher charges for aeronautical services. However, Virgin Blue does not agree that the appropriate value for an airport's asset base should be the value of its assets as at 30 June 2005.

Virgin Blue submits that it is inappropriate to select an arbitrary "cut off" point for asset valuations.

Virgin Blue proposes that the Commission adopt the alternative approach set out by the Allen Consulting Group.[60] In summary, the Allen Consulting Group proposes that the starting asset values for airports be those values implied from the prices allowed under the previous price cap regime, which is consistent with the approach taken in many other industries.

8 PRICE MONITORING – THE COMMISSION'S PROPOSAL

8.1 Has price monitoring been effective?

Virgin Blue's assessment of the current monitoring regime and its suggested improvements are set out in detail in its earlier submission, and summarised below.

The current price monitoring regime key weaknesses are:

[60] The Allen Consulting Group, "Productivity Commission Review of Airport Pricing, Issues arising from the Draft Report", October 2006, chapter 3

(a) that the ACCC's role in relation to price monitoring, and therefore the utility of its reports, is limited, such that the reports do not provide an adequate basis on which to review compliance with the Government's Review; and

(b) there are insufficient incentives for airports to engage in negotiations with airlines on a reasonable, commercial basis, rather than a "take it or leave it" basis.

However, the price monitoring regime can be improved in order to address those weaknesses. In particular, Virgin Blue proposed amendments that would enhance the environment for commercial negotiation, being:

(a) in the event that commercial negotiations fail, airlines and major airports would have the ability to refer to arbitration by the ACCC any dispute over the terms and conditions on which aeronautical services are provided by the airport;

(b) in order to assist commercial negotiations and reduce the need for any arbitrations:

(i) the ACCC would issue pricing and costing guidelines addressing key issues in negotiations over the provision of aeronautical services such as the valuation of major airport assets, the allocation of costs between aeronautical and non-aeronautical services and the basis for charging for particular aeronautical services; and

(ii) the current shortcomings in the price monitoring regime would be addressed to ensure that airlines and airports have up to date, accurate and transparent information about airports' costs and prices.

However, the Commission does not address these suggested improvements to the regime in its Draft Report. Rather, the Commission suggests that additional commentary accompany price monitoring reports. Commentary may be interesting, but is not a substitute for adequate data.

Virgin Blue submits that the Commission should consider improving the current price monitoring regime. Improvements would foster the environment for commercial negotiation, rather than hindering it. For the reasons set out above, in the absence of an effective regulatory regime:

(a) airports will not have an incentive to negotiate, because they are in a position to make offers to airlines on a "take it or leave it" basis;

(b) the airports' pricing conduct will not be constrained; and

(c) there will be a deadweight loss to society.

8.2 The frequency of price monitoring should not be reduced

Virgin Blue strongly disagrees with the Commission's proposal to reduce the frequency of price monitoring. Already the delay between price changes and reporting of those changes can be excessive. Under the Commission's proposal, a price increase implemented on 31 July 2008 would not be reported until early 2011, almost three years later. Given that the Commission acknowledges that compliance costs for price monitoring have been quite modest,[61] there is no reason for this change.

The Commission states that contracts in this sector generally last for five years, such that biennial reporting should not materially reduce the credibility or usefulness of the monitoring process.[62] However, as discussed in section 4.5 above, those agreements typically allow airports to increase their charges unilaterally during the contract term, such that timely reporting remains critical.

Virgin Blue agrees with the Commission's comments that comparisons over more than one year help put reported price movements in better context, but this can be easily achieved through additional trend analysis in annual price monitoring reports.

8.3 Price monitoring should apply to all major airports

As set out in its submission dated 21 July 2006, Virgin Blue believes that price monitoring (and its proposed negotiate arbitrate model for aeronautical services) should apply to the 12 core regulated airports plus Cairns.

Virgin Blue is concerned that rather than ensuring that price monitoring covers all major airports with market power, the Commission is considering removing an airport (Darwin) from the scope of the existing price monitoring regime.

Virgin Blue believes that, at a minimum, prices monitoring should continue to apply to Darwin Airport. Darwin is the capital of the Northern Territory and is an important element in a national network. Further, Virgin Blue is very concerned by the trend in aeronautical charges at Darwin Airport. On the information in the Draft Report, average aeronautical revenue per person at Darwin Airport has more than tripled since 2000-01, and has increased by 60% since 2001-02 (see p 15).

The reasons advanced why airlines should not be concerned by this increase in charges are that there has been increased investment at Darwin Airport recently, and because it is smaller than other monitored airports, the security costs per passenger are higher (Draft Report p 17). The Commission states that these increases have reflected the unwinding of the previous, "commercially unsustainable" charges (p 60). However, commercial sustainability is meaningless

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61 Draft Report, p 80

62 Draft Report, p 80

when dealing with the sunk costs that account for the majority of the airport's assets. Virgin Blue considers that these increases underline the need for continued monitoring, not its removal.

The Commission advances two reasons for removing Darwin from the price monitoring regime-:

(a) Qantas now provides 85% of domestic flights into Darwin and therefore Qantas would have countervailing power in dealing with Darwin Airport; and

(b) the airport faces competition for international flights from Broome and Cairns airports.

Virgin Blue gains little comfort from this reasoning. In relation to the first argument, there is no reason to believe that simply because Qantas may have increased bargaining power with Darwin Airport (which is doubted) this will flow through to the charges paid by Virgin Blue. For example, when Darwin Airport was introducing checked baggage screening to comply with Government requirements, it proposed two alternative pricing structures to its airline customers:

(a) the first option levied a charge on international carriers only; and

(b) the second option which levied a charge on both international and domestic airlines.

The second option required Virgin Blue to pay over $500,000, whereas Virgin Blue paid nothing under the first option.

While Virgin Blue preferred the first option, Qantas and the international airlines preferred the second option. The second option was ultimately introduced over Virgin Blue's objections.

As can be seen from the Tribunal's decision in *Re Virgin Blue Airlines* and the clear example above, to the extent that a larger airline may have some increased bargaining power, any benefits are likely to flow to that larger airline and not to its competitors.

In relation to the Commission's second argument, that Darwin Airport faces competition for international flights from Cairns and Broome, this will not act to constrain aeronautical charges for domestic airlines.

9 ENCOURAGING COMMERCIAL NEGOTIATION

9.1 The current regime does not give airports an incentive to negotiate

The Commission has placed a strong emphasis on the primacy of commercial negotiation. Commercial negotiation is the best tool to reach competitive outcomes in a competitive market. However, commercial negotiation, without more, is not the best process to use to reach an efficient outcome in a monopoly situation.

Virgin Blue agrees that, if there was an effective constraint on the airports' market power, then commercial negotiation would be the preferable way for airports and airlines to reach agreement on the terms and conditions on which airports supply aeronautical services. However, without an effective constraint, airports will simply dictate terms which airlines will have no realistic option but to accept (as happens under the current regime).

In considering an airport specific negotiate arbitrate model, the Commission appears to believe that price monitoring will constrain the exercise of market power by airports. The Commission states:

> "*The market power enjoyed by the major airports will, of course, condition negotiations and the outcomes they deliver. However, such power is already catered for through price monitoring — which the Commission has proposed should continue after 2007 — and the Part IIIA regime.*" (Draft Report, p 112)

As noted above, this statement is inconsistent with both the findings of the Tribunal in *Re Virgin Blue Airlines* and the Commission's views elsewhere in the Draft Report where it states that such a constraining effect may not be large (p 165) and that it too soon to tell what effect it will have (p 53).

Virgin Blue submits that in considering a negotiate-arbitrate model for aeronautical services, the Commission must accept that there are no other effective constraints on the market power of airports. In such circumstances, the best incentive to foster an environment conducive to meaningful negotiation is the availability of an arbitration mechanism, together with detailed pricing and costing guidelines that give the parties guidance as to the likely arbitrated outcome.

9.2 **An arbitration mechanism enhances incentives to negotiate**

The Commission has expressed a concern that if there were an airport-specific arbitration regime, parties would view arbitration as a default. However, a well-designed negotiate-arbitrate model can enhance the environment for commercial negotiations. Virgin Blue notes that the negotiate-arbitrate model that it has proposed is the model that underpins the operation of the National Access Regime in Part IIIA of the TPA.

The background to any negotiate-arbitrate regime is that if parties behave in a reasonable, commercial manner, there need be no arbitration. This is the ideal situation and Virgin Blue's preferred approach to the negotiation of terms and conditions for the provision of aeronautical services. The aim of arbitration is to act as a "circuit breaker" in the event that commercial negotiations fail (and it may be necessary on rare occasions to resort to such a circuit breaker). However, the conduct of arbitrations is not the only valuable element of such a regime. It is the *threat* of arbitration that would provide parties with an incentive to negotiate on a reasonable, commercial basis.

Terms and conditions of access negotiated on a commercial basis have some clear benefits over an outcome determined by arbitration, including:

(a) certainty of outcome, as terms are agreed by the parties. This also gives the parties the potential to negotiate flexible terms and conditions;

(b) speed of outcome, as even the most efficient arbitration processes take time; and

(c) cost savings, as costs associated with arbitration are avoided.

The Commission has previously acknowledged these benefits of a negotiate-arbitrate model. For example, in its review of the National Gas Access Regime, the Commission stated:[63]

> *In certain circumstances, an effectively designed negotiate–arbitrate framework can encourage commercial negotiation and innovation, and reduce regulatory compliance costs relative to the Gas Access Regime, while still providing a regulatory mechanism to prevent service providers from attempting to deny access to, or extract monopoly rents from, access seekers. For large users, there are benefits from greater flexibility in the terms and conditions of access that can be achieved through commercial negotiations.*

In addition, the publication of pricing and costing guidelines, as discussed in section 11.4A of Virgin Blue's submission of 21 July 2006, would provide guidance to both the access seeker and the access provider as to the likely arbitrated outcome. This would provide an incentive to negotiate without resorting to arbitration, while limiting the access provider's ability to exercise any monopoly power, knowing that if it were to do so the access seeker would likely resort to arbitration. The Commission acknowledged the effect of pricing principles in its review of the National Access Regime:[64]

> *Without pricing principles, negotiation can be somewhat unguided – at least until such time as arbitrated precedents are established. This could take a long time. From this perspective, pricing principles would be a particularly important adjunct to speedy negotiation during the early stages of an access regime.*

Virgin Blue does not consider that parties would use arbitration as the default approach to determining the terms and conditions for the provision of aeronautical services, because:

(a) there are clear benefits associated with determining those terms and conditions on a commercial basis, as discussed above; and

(b) that suggestion is not borne out by experience with other access models which include an arbitration mechanism (see examples in the box below).

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63 PC, *Review of the Gas Access Regime*, PC Inquiry Report No 31, 11 June 2004 at p 335

64 PC, *Review of the National Access Regime*, PC Inquiry Report No 17, 28 September 2001 at p 201

Experience with negotiate-arbitrate regimes

NSW rail access regime

The NSW rail access regime provides for the Independent Pricing and Regulatory Tribunal (**IPART**) to arbitrate disputes between the Rail Infrastructure Corporation and access seekers. Since the establishment of the regime in 1996, IPART has only been required to determine one dispute.[65]

National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code)

The Gas Code provides for disputes about the terms and conditions of access to covered gas pipelines to be arbitrated by the ACCC or a jurisdictional regulator (depending on the nature of the dispute). As far as Virgin Blue is aware, no arbitration has been determined since the introduction of the Gas Code in 1997.

Part IIIA of the TPA

As of the date of this submission, there is yet to be any arbitration conducted by the ACCC under Part IIIA of the TPA, despite a number of airport services being declared services under Part IIIA. Once services are declared, parties have the option of notifying a dispute with the ACCC for arbitration if they are unable to agree on the terms and conditions for access to the declared service.

The airport services that have been declared under Part IIIA f the TPA include:

(a) through the operation of s 192 of the Airports Act 1996 (Cth) (now repealed) all airport services provided at the core regulated airports were declared starting 12 months after the core regulated airport was privatised. These declaration expired on 1 July 2002 for Melbourne, Brisbane and Perth airports and on 1 July 2003 for Adelaide, Gold Coast, Hobart, Launceston, Alice Springs, Canberra, Townsville and Darwin airports. The declaration of airport services at Sydney Airport only lasted 24 hours. Airport services were defined under s 192 of the Airports Act to include all services which were necessary for the purposes of operating and/or maintaining civil aviation services at the airport and which were provided by means of significant facilities at the airport, being facilities that could not be economically duplicated;

(b) ramp handling services at Sydney Airport for the period from 1 March 2001 to

[65] Rail Infrastructure Corporation, Network Access Information Pack section 6, "Previous arbitrations and determinations"

1 March 2006 (see *Sydney International Airport* [2000] ACompT 1); and

(c) the Airside Service at Sydney Airport for a period of 5 years from 9 December 2005.

There are a number of mechanisms that could be adopted in the event (which Virgin Blue considers unlikely) that a negotiate-arbitrate model resulted in parties resorting too quickly to arbitration. Such mechanisms include final offer arbitration and cost penalties for parties who resort to arbitration unreasonably.

However, Virgin Blue does not consider that there is a demonstrated need for any such measures. Given the experience in other industries (and in the aviation industry) to date, there is no reason to believe that parties will resort to arbitration excessively. Nevertheless, to cater for any concern that this might occur, Virgin Blue considers that it would be appropriate for the Commission to be asked to review the operation of the negotiate-arbitrate model after an initial probationary period (say three to five years) and to recommend the adoption of any mechanisms deemed necessary to improve the effectiveness of the model.

In conclusion, Virgin Blue considers that the Commission's concerns over the outcome of a negotiate-arbitrate model are misplaced. Given the absence of any other identified constraint, a negotiate-arbitrate model of the sort proposed by Virgin Blue offers the best outcomes for airports, airlines, the travelling public and society as a whole.

Attachment A

Responses to Draft Recommendations

Draft recommendation 4.1

A modified airport price monitoring regime should apply for five years from July 2007.

- **These new arrangements should clearly signal that a subsequent more detailed scrutiny of an airport's charges, including as appropriate through the Part VIIA inquiry provisions, will occur if the monitoring process reveals strong evidence of significant misuse of market power.**
- **The monitoring process should also make explicit provision for airports and those using monitored services to comment on the reasonableness of charging and related outcomes, and require the Australian Competition and Consumer Commission to include that commentary in its monitoring reports.**

Virgin Blue agrees that price monitoring should be continued, and also that modifications to the current price monitoring regime are necessary. However, the amendments proposed by the Commission do not remedy the weaknesses in the current regime because:

(d) they do not identify a clear trigger for the imposition of heavier handed regulation. Rather, if the monitoring process reveals strong evidence of a significant misuse of market power, which is in itself a concept which lacks clarity, there is a further lengthy step before any actual sanction (if there is to be one) is imposed (see section 3.1); and

(e) the addition of commentary to monitoring reports does not address the inadequate scope of the ACCC's information gathering powers which limits the utility of its reports (see section 8.1). Without improvement, the ACCC may be unable to identify the circumstances that would give rise to a Part VIIA inquiry under the Commission's proposal. Nor does the addition of commentary improve the (weak) credibility of the threat or re-regulation.

The Commission's proposed regime therefore fails to provide an environment that will foster commercial negotiations between airports and airlines of the sort that would occur in competitive markets.

Draft Recommendation 4.2

The new price monitoring regime should apply to Adelaide, Brisbane, Canberra, Melbourne, Perth and Sydney Airports. Darwin Airport should not be subject to monitoring once the current arrangements lapse.

Virgin Blue considers that the price monitoring regime should apply to all of the core regulated airports plus Cairns. Therefore Darwin Airport should not be excluded from the price monitoring regime (see section 8.3).

Draft Recommendation 5.1

The new price monitoring regime should continue to operate on a dual till basis. The services covered should be those specified in the current proposal from the Department of Transport and Regional Services to align the relevant parts of the Airports Act and the directions pursuant to the Trade Practices Act giving effect to airport price monitoring.

Virgin Blue has no comment on the dual till question, however Virgin Blue strongly supports the revised definition of aeronautical services as suggested by the Department of Transport and Regional Services.

Draft Recommendation 5.2

The Government should consider asking the Australian Competition and Consumer Commission to separately monitor charges for car parking and other landside vehicle services at the major airports.

Virgin Blue supports this recommendation.

Draft Recommendation 5.3

Monitoring of service quality under the new regime should be limited to the reporting by the Australian Competition and Consumer Commission of commentary sought from airports and their customers on overall quality outcomes and particular quality problems, and any information provided by them to support that commentary.

Virgin Blue has no comment on this recommendation.

Draft recommendation 5.4

Price and service quality monitoring outcomes should be combined in a single report, published every two years. To align with the proposed end-of-period review in 2011 (see draft recommendation 5.5), the first of these reports should be published in early 2009 and cover outcomes during 2006-07 and 2007-08. To accommodate this new reporting arrangement, there should be no separate review of outcomes for the final year of the current price monitoring regime.

Virgin Blue agrees with the proposal to combine price and service monitoring outcomes in a single report.

However, Virgin Blue disagrees with the proposal to reduce the frequency of price monitoring (see section 8.2). Under the proposal, a price increase might not be reported until almost 3 years after the event. Given that many contracts between airports and airlines allow for unilateral price increases during the term of existing contracts, timely reporting is critical.

Draft recommendation 5.5

The new price monitoring regime should be reviewed in 2011 to determine what arrangements should apply thereafter. Assessments under that review, and the operation of price monitoring in the intervening period, should be governed by an overarching set of principles. These should be the current 'Review Principles', augmented to specify that:

- **the benefits of improved productivity at the price monitored airports should be shared between airport operators and their customers; and**
- **future asset revaluations should not generally provide a basis for higher charges (see draft recommendation 6.2).**

Virgin Blue does not object to a further review of the price monitoring arrangements in 2011. However, Virgin Blue has the following comments in relation to the Commission's augmentation of the Review Principles:

(a) Virgin Blue accepts that it is important for infrastructure owners to be provided with financial incentives for efficiency, however, they should not receive windfall gains for improved productivity that is not attributable to their efforts. For that reason, it is appropriate that airports be permitted to retain a share of the benefits flowing from improvements in their technical efficiency, but not of productivity growth as a result of increased passenger numbers and the adoption of new technology as assets are replaced or new investments made (see section 5.2);

(b) there must be clear parameters on how any benefits should be "shared". For example, it could be said that an airport that passes on 1% of a cost reduction has shared the benefit, but this is unlikely to be the result the Commission envisages (see section 5.2); and

(c) Virgin Blue agrees that future asset revaluations should not provide a basis for higher charges. However, Virgin Blue does not agree that the "cut off" point of 30 June 2005, identified by the Commission, is appropriate (see further responses to draft recommendations 6.1 and 6.2).

Draft recommendation 6.1

Under the new price monitoring regime, the value of an airport's asset base for monitoring purposes should be:

- **the value of tangible (non-current) aeronautical assets reported to the Australian Competition and Consumer Commission as at 30 June 2005, adjusted as necessary to reflect the proposed service coverage of the new regime (see draft recommendation 5.1);**

- **plus new investment (at values agreed with customers);**

- **less depreciation and disposals.**

Virgin Blue agrees with the Commission's proposal not to allow future revaluations to affect prices, but does not agree that the "cut off" point of 30 June 2005 is appropriate. See Chapter 2 of the Allen Consulting Group Report dated 13 October 2006, which sets out an alternative method for the calculation of appropriate starting regulatory asset values, based on prevailing prices under the price cap.

Draft recommendation 6.2

The principles governing the operation and end-of-period review of the new price monitoring regime should stipulate that, unless agreed with customers, further asset revaluations should not provide a basis for higher charges for monitored aeronautical services.

As stated above, Virgin Blue agrees with the Commission's proposal not to allow future revaluations to affect prices, subject to the calculation of appropriate starting regulatory asset values.

Draft recommendation 7.1

An airport-specific arbitration regime, or a requirement that agreements between airports and airlines include provision for binding independent dispute resolution, should not be introduced at this time.

Virgin Blue strongly disagrees with this recommendation. A well designed arbitration mechanism, complemented by detailed pricing and costing guidelines, would enhance the environment for commercial negotiation while ensuring efficient investment. Virgin Blue agrees with the Commission's position that commercial negotiation is the preferable approach for setting the terms and conditions for the provision of airport services so long as there is an effective constraint on airports' market power. Virgin Blue does not consider that the Commission's concerns that parties would view arbitration as a default option valid are well-founded. Rather, it is the threat of arbitration, together with guidance as to a likely arbitrated outcome, that gives the parties an incentive to negotiate on a reasonable, commercial basis. In the absence of effective regulation, airports do not have such an incentive (see section 9).

Attachment B

Revenue Load Factor Data

The figures in the Table 3.1 are aggregated at the group level: for Qantas they included Qantas domestic, Qantas international, Australian Airlines, QantasLink and Jetstar; and for Virgin Blue they include both Virgin Blue (domestic) and Pacific Blue (international). Therefore these figures compare like with like because they compare the aggregate domestic and international operations of Qantas with the aggregate domestic and international operations of Virgin Blue.

In its submission, Melbourne Airport compared the load factor of the aggregate domestic operations of Qantas with that of the aggregate domestic and international operations of Virgin Blue. While this is not comparing like with like, even this comparison over the 12 month period shows that in most months, the load factor for the aggregate domestic and international operations of Virgin Blue exceeded the load factor for the aggregate domestic operations of Qantas.

Table B1 Load Factors: Melbourne Airport Calculation July 2005 to June 2006

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Qantas Domestic Group	79%	77%	80%	81%	78%	-	80%	73%	75%	79%	73%	-
Virgin and Pacific Blue	82%	78%	81%	80%	79%	79%	81%	76%	75%	77%	72%	74%
Higher Load factor	VB/ PB	VB/ PB	VB/ PB	QDG	VB/ PB		VB/ PB	VB/ PB	-	QDG	QDG	

source: ASX announcements from Qantas and Virgin Blue

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Virgin Blue notes that all of the load factor figures in this Attachment B are, like the figures discussed in the body of the submission, revenue load factor data (ie revenue seat kilometres divided by available seat kilometres) and are therefore weighted according to the distance travelled.

For the reasons discussed above in the body of the submission, load factor data is not available from Qantas for the months of December and June.