



**Productivity Commission Inquiry: Economic
regulation of airport services**

Reply submission by Virgin Australia Airlines

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1 Introduction and executive summary

Virgin Australia has read the Productivity Commission's draft report dated August 2011 in relation to its review of the economic regulation of airport services (**the Draft Report**). In this submission, Virgin Australia responds to some of the draft findings and draft recommendations in the Draft Report.

Virgin Australia's position in relation to the economic regulation of airport services is quite simple. Major airports in Australia are natural monopolies. There are no effective substitutes for their services. Unless constrained, monopolists will act to increase prices above efficient levels, reduce the quality of the services they offer, or both. Virgin Australia has seen no reason to suggest that major airports act any differently from other monopolists. This is especially the case where managers of privatised airports have duties to maximise returns to their shareholders.

Under the current regime, Virgin Australia does not consider that there are any effective constraints on the monopoly powers of major airports. The regime is wholly ineffective in this regard. Two of these supposed constraints, the countervailing power of airlines and the impact of complementarities between aeronautical and non-aeronautical services are discussed in section 3.

Virgin Australia also does not consider the current price monitoring regime and the declaration provisions to be effective. These mechanisms are intended to provide safeguards that enable concerns about an airport's behaviour to be acted on. The declaration process in particular is ineffective at constraining airports' market power due to the time, cost and uncertainty associated with it. Virgin Australia has commented on the reasons for the limited use of existing regulatory mechanisms to date and the Commission's draft findings regarding service monitoring in sections 2.3 and 2.4 below.

The proposed show cause process is not an appropriate solution to this problem. A show cause mechanism was considered following the last review by the Productivity Commission and failed to attract any support from any section of the industry. We do not believe that the show cause mechanism would in any way be effective to constrain airports from abusing their monopoly power. This is discussed further in section 2.2.

Virgin Australia is disappointed because, even though the Commission recognises that the existing regime would benefit from a credible threat, it has dismissed the option that would provide such a threat, the negotiate-arbitrate model, in favour of a proposal that lacks any real teeth.

We believe that in the absence of an effective constraint on their monopoly power, major airports will continue to increase their charges above efficient levels and set terms and conditions for use of their facilities that would not prevail in a competitive market. The harm from this conduct extends beyond the impact that it has on airlines and other users of airport services. Increased airport charges result in higher fares. Since most passengers are very price-sensitive, the lack of effective checks and balances in the setting of airport charges will result in reduced demand for air travel and a welfare loss to a society as a whole. It is not simply a question of allocating profits between airports and airlines.

Virgin Australia is very concerned that its passengers do not have any real sense of the prices that they are paying indirectly for airport use. This is becoming an increasingly urgent issue for Virgin Australia as these charges have risen, and as they are likely to continue to increase rapidly in the absence of any effective constraint on airports. Therefore Virgin Australia is giving considerable thought to how it can make airport charges more transparent to the travelling public, so that they can see how much they are paying to airports and how those amounts change over time.

Virgin Australia remains of the view that a negotiate-arbitrate model of the type set out in its submission dated 18 April 2011 is the most effective model for regulating the supply of airport services in Australia. It also considers that this model should be supported by price and costing guidelines and improved monitoring.

Virgin Australia also agrees that benchmarking measures should be adopted for use in assessing airport operating costs and charges so that trends can be monitored. However, it has concerns about benchmarking analysis referred to by the Commission in its Draft Report as set out in section 4.

Virgin Australia has also made some comments in this submission in relation to airport investment, the level of airport charges, airport car parking and land access, and the inclusion of capital costs in price monitoring.

2 Response to draft recommendations and findings regarding regulation

2.1 Comments regarding the negotiate-arbitrate model

Virgin Australia has considered the Commission's recommendations set out in the Draft Report, including Draft Recommendation 11.3, which recommends against an airport-specific arbitration regime activated by deemed declarations of airports and mandatory codes of conduct / guidelines.

Virgin Australia remains of the view that a negotiate-arbitrate model of the type set out in its submission dated 18 April 2011 is the most effective model for regulating the supply of airport services in Australia. It also considers that this model should be supported by price and costing guidelines and improved monitoring.

Virgin Australia sets out its reasons for preferring this model in its submission dated 18 April 2011 at section 10.2(a) and 10.6. In summary:

- Virgin Australia has consistently stated that its preference is to commercially negotiate agreements with airports.
- However, negotiations between (at least) major airports and airlines have rarely been conducted on a truly commercial basis. This is due in part to the market power that major airports possess in supplying aeronautical and related services.
- Virgin Australia believes an incentive is needed to encourage airports to negotiate commercially in relation to the supply of these services. Virgin Australia believes that the best way to retain the efficiency and flexibility of commercial negotiation whilst providing an incentive for airports to negotiate is to provide for a 'circuit breaker' where a party would have the option of referring a matter to independent arbitration if the parties could not agree commercially.
- Virgin Australia's experience with the declared Airside Service at Sydney Airport, where it was able to quickly and commercially resolve its dispute once the threat of arbitration became available, has confirmed its belief in the benefits of this model.

In support of its Draft Recommendation, the Commission has raised a number of concerns about expedited access to arbitration. These include the concerns that such access: could undermine light-handed regulation, would not necessarily provide strong incentives to engage in commercial negotiation and would provide scope for a second opinion. It stated that examples of the limited use

of arbitration mechanisms provided to it to demonstrate the contrary operated concurrently with commercial agreements (with dispute resolution mechanisms), and therefore are not persuasive.

Virgin Australia does not consider that the evidence supports these concerns or the Commission's conclusions. In fact, there is considerable evidence that access to dispute resolution mechanisms such as arbitration tends to assist commercial negotiation.

In response to the Commission's 2006 Inquiry, both Virgin Australia (then Virgin Blue) and Qantas provided examples of where access to independent dispute resolution had not undermined the commercial negotiation process. Qantas referred to the periods between 1998 to 2002 and 1999 to 2003 during which 'airport services' were effectively declared pursuant to the deeming provisions under s 192 of the *Airports Act 1996* and to the period of declaration for cargo handling services at Sydney Airport. Virgin Australia referred to examples from the rail and gas pipeline industries. In relation to this Inquiry, Virgin Australia has already referred in its submission dated 18 April 2011 to its experience with the declared Airside Service at Sydney Airport.

There are further examples from overseas that show that parties in a regulatory framework with access to such mechanisms are willing and able to negotiate settlements to the extent that they are allowed to do so. In his article, *Australian airport regulation: exploring the frontier*, Professor Stephen Littlechild has referred to examples of this in the context of the energy sectors in the US, in relation to pipeline line toll cases in Canada, and in relation to the aviation industry in the UK. Littlechild has also referred to the latest EU Airport Charges Directive which establishes a procedure under which there is regular consultation between an airport and its users about airport charges. Under this procedure, either party may seek the intervention of an independent supervisory authority in the event of a disagreement.¹

It is clear that the current price-monitoring regime has not been effective in preventing major airports from earning aeronautical revenues significantly above efficient costs or from levying charges in inefficient and anti-competitive ways. The impact of this goes beyond a mere wealth transfer from airline shareholders to airport shareholders. Charges above efficient levels result in reduced passenger numbers and welfare losses to society as a whole. Going forward, Virgin Australia believes that the Commission must recommend a regulatory regime that will prevent airports from raising charges significantly above efficient levels, while also retaining maximum flexibility to allow airports and airlines to negotiate and agree on efficient and competitive terms and conditions for the use of airports' facilities.

2.2 Comments regarding the proposed show cause process

Virgin Australia has considered the Commission's Draft Recommendation 11.1, which recommends empowering the ACCC to issue a show cause direction, and the Commission's information requests on whether:

- the ACCC should be responsible for both issuing show cause directions and conducting any subsequent Part VIIA inquiry; and
- there are additional readily accessible financial or other data that would assist the ACCC to determine if a 'show cause' direction was warranted.

Virgin Australia does not consider that a show cause process is an appropriate solution to constrain airports' monopoly power. A show cause mechanism was considered following the last review by the Productivity Commission and failed to attract any support from any section of the industry. We do not believe that the show cause mechanism would in any way be effective to constrain airports from

¹ Stephen Littlechild, 'Australian airport regulation: exploring the frontier' (2011), University of Cambridge, 22-24.

abusing their monopoly power. For a start, the show cause mechanism proposed by the Commission would only be triggered by price related concerns.

Further, Virgin Australia does not consider that it would be effective in constraining prices. Virgin Australia does not believe that it represents a credible threat of punishment for abusing monopoly power for a range of reasons. First, it would appear that the decision to issue the show cause direction can only be made on the basis of the price monitoring information provided by airports to the ACCC. This information is incomplete and not well adapted to identify misuses of monopoly power. Not allowing the ACCC to issue a show cause direction to an airport on the basis of complaints from airport users, no matter how compelling their evidence of abuse, further neuters the effectiveness of this constraint.

Secondly, the hurdle has been set far too high to be effective. On the basis of the mechanism recommended by the Commission, an airport would be able to abuse its monopoly power in any way it liked so long as it did so only for one year. The ACCC would only be able to issue a show cause direction under the Commission's proposal where the ACCC can come to the conclusion that:

there is prima facie evidence that an airport has, over time, shown a consistent pattern of achieving aeronautical returns in excess of a reasonably expected band of outcomes.

This hurdle leaves ample room for airports to abuse their monopoly power in a range of price and non price ways without fear of even a show cause direction.

The proposed mechanism is also too slow acting to be of any benefit. The ACCC would only be alerted to any monopolistic pricing well after (up to 12 months after) it has been imposed on an airline, potentially in a binding 5 year agreement.

Finally, even if a show cause direction was issued, and a Part VIIA inquiry held, given the position taken by airports that any constraint on airport charges increases the risk of investment in infrastructure, we doubt any effective mechanism would be introduced, even if there were adverse findings.

That said, Virgin Australia has suggested in Attachment A the types of financial and other information that it considers would be useful to the ACCC if any show cause process were to be introduced.

2.3 Comments regarding the use of existing mechanisms and ACCC powers

The Commission has commented that the light-handed regime includes safeguards that enable concerns about an airport's behaviour to be acted on, yet:

- the ACCC has not called for, nor has the Minister instigated, a price investigation;
- for nearly a decade no airport user has applied to have airport services declared, nor has the Minister commenced such an application;
- notwithstanding criticism levelled at Sydney airport consequent to its domestic airside services being declared for five years to December 2010, only one user notified the ACCC of a dispute — which was resolved commercially — and no user sought to have the declaration extended.²

Virgin Australia considers that these statements fail to allow for the serious failings in the current regime.

² See Productivity Commission, *Economic Regulation of Airport Services*, Productivity Commission Draft Report (August 2011) 233, 240-241.

Firstly, in relation to the comment that the ACCC has not called for a price investigation, Virgin Australia points out that, as noted above, the ACCC can only hold such inquiries where the Minister requires the ACCC to hold a price inquiry or gives his or her approval.

Virgin Australia is also concerned about the Commission's comments that, for nearly a decade, no airport user has applied to have airport services declared nor has the Minister commenced such an application. Part IIIA in its current form is an ineffective constraint on airports' abuse of their market power because of the uncertainty, expense and delay involved in seeking declaration for services provided by airports. It is quite likely that any future application to declare an airport service would be even more difficult due to changes that have been made to Part IIIA to raise the bar for declaration and recent Federal Court decisions that have imposed stricter tests for the application of Part IIIA criteria (see for example *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2011] FCAFC 58). For these reasons, it is not surprising that no airport is currently subject to any declaration, and only Sydney Airport has ever had any services declared under Part IIIA.

The Commission has also stated that only one user of domestic airside services at Sydney Airport has notified the ACCC of a dispute and no user sought to have the declaration extended.

Virgin Australia considers that the lack of arbitrated disputes is an indication that the threat of ACCC arbitration had facilitated commercial negotiations between Sydney Airport and users in relation to the declared airport services to resolve commercial disputes, instead of it being an indication that there were few commercial disputes.

Further, access declarations cannot be simply 'extended'. A party wanting to extend the Sydney Airport declaration would be required to undertake the declaration process from the beginning. Virgin Australia is not surprised that there was no such 'extension' by any party following the expiry of the Sydney Airport declaration given the time and cost involved in the original process.

2.4 Comments regarding service monitoring

The Commission has made the following draft findings:

- Recent quality of service monitoring for the overall and passenger survey results alone do not indicate any persistent trends that would suggest the misuse of market power (Draft finding 6.2).
- Quality of service ratings from airline surveys are notably lower, including ratings of 'poor' for both Sydney and Perth airports. Concerns raised by the ACCC appear to place greater emphasis on the airline surveys (Draft Finding 6.3).

Overall quality of service ratings are calculated by the ACCC for its monitoring reports using qualitative criteria and subjective surveys, including the passenger surveys referred to in the Draft Finding 6.2.

Virgin Australia is concerned that the passenger surveys may not be an accurate representation of the quality of service provided to all users at airports. In part, this is because airports conduct passenger surveys themselves, unlike the airline and border agency surveys which are conducted by the ACCC.

Further, as acknowledged by the Commission, passenger ratings may not provide the most reliable indicator of quality of service at airports. This is because, while airports provide much of the services and facilities used by passengers, so do airlines and border agencies, and customers may not be sufficiently aware of the mix of providers involved. The Commission has stated that an implication of this could be that if passengers were better informed, airports' survey ratings could be even higher.

Virgin Australia supports the implication of the ACCC in its monitoring report that the opposite is more likely.

Virgin Australia also suggests that while the overall quality of service ratings in the ACCC's monitoring report may be higher than the ratings given by airlines and border agencies, this is likely to be a function of the manner in which the overall ratings are calculated (ie by aggregating the airlines and border agency ratings, and other criteria, with the higher passenger ratings).

In addition to the above, Draft Recommendation 11.5 recommends that, where an airport has service level agreements with all of its regular passenger airlines which stipulate methods for recourse in the event of a failure to meet a standard, an airline survey should no longer be conducted for that airport. Virgin Australia disagrees with Draft Recommendation 11.5 and is concerned that this will lead to lower quality of service outcomes at monitored airports.

3 Supposed constraints on airports' market power

3.1 The countervailing power of airlines

The Commission has commented in Draft Finding 9.4 that:

The divergence in the observations and assertions made by airports, on the one hand, and their customers on the other, seems to reflect 'positioning' to either protect or change the distribution of profits between them. While not surprising, testing the veracity of opposing propositions is difficult. Ultimately, the claim and counter claim nature of the evidence means that it is not possible to make a definitive call that greater regulatory intrusion is warranted. Some negotiations are said to work well and others not. These differences might reflect personalities and experience as much as systemic parameters. There is considerable scope to improve commercial negotiation as it has not yet achieved the level of maturity envisaged with the lifting of price regulation nearly a decade ago.

Virgin Australia is concerned that the Commission has failed to sufficiently take into consideration the impact of airlines' lack of countervailing power in negotiations with airports.

In 2006, the Australian Competition Tribunal's decision in *Virgin Blue Airlines Pty Limited* (2006) ATPR 42-092 noted:

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.³

The Commission itself has previously conceded in 2006 that airlines' countervailing power was not an effective constraint on airports' market power despite its earlier finding in its 2001 inquiry that they were. In its 2006 report, the Commission stated:

More generally, with the benefit of hindsight, it has become apparent that some of the 'market' constraints on airports' behaviour are not as strong as was previously envisaged. For example, airlines generally have only modest countervailing power in dealing with the major airports. Also, the negative impact of higher charges for aeronautical services on passenger traffic, and hence on airports' non-aeronautical revenues, does not appear to be significant.⁴

³ *Virgin Blue Airlines Pty Limited* (2006) ATPR 42-092 at [485] – [486].

⁴ Productivity Commission, *Review of Price Regulation of Airports Services*, Report no 40 (14 December 2006) p XVII.

Virgin Australia does not consider that developments since 2006 have altered this position and, in sections 5 and 6 of its 18 April 2011 submission, Virgin Australia has provided considerable detail regarding the difficulties it experiences in negotiations with airports.

3.2 Complementarities between aeronautical and non-aeronautical services

The Commission has commented that 'airport operators have a commercial incentive to consider restraining aeronautical charges to airlines to indirectly induce more passengers to use their airport, and thereby potentially contribute to non-aeronautical revenues'.⁵ It has made the following information request:

The Commission requests additional information on whether an airport's ability to earn non-aeronautical revenue provides an incentive to constrain aeronautical charges, and if so, to what extent this currently occurs.

Virgin Australia is concerned that the Commission's draft report does not recognise the conclusions already reached by the Commission and the Tribunal regarding the constraint posed by non-aeronautical revenues. Virgin Australia is considering its position in relation to a further, more targeted submission on this issue, and, in the meantime, makes the following comments.

The Tribunal's decision in *Virgin Blue Airlines Pty Limited* (2006) ATPR 42-092 noted:

*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.*⁶

Indeed, Sydney Airport's own economic expert 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 to \$58 (an increase of almost 20 fold).

Virgin Australia considers that while the Tribunal's assessment was based on the circumstances of Sydney Airport, the conclusions reached by the Tribunal would be equally applicable to other major airports. While the precise level of charges at which a constraint posed will be effective will vary from airport to airport, given that the level for Sydney Airport was found to be almost 20 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. Virgin Australia is not aware that any airport has attempted to perform the calculation to show that the constraint would, in fact, be effective given its particular circumstances.

The Commission itself also conceded in 2006 that the constraint posed was not effective despite its earlier finding in its 2001 inquiry that it was. In its 2006 report, the Commission stated:

*More generally, with the benefit of hindsight, it has become apparent that some of the 'market' constraints on airports' behaviour are not as strong as was previously envisaged. For example, airlines generally have only modest countervailing power in dealing with the major airports. Also, the negative impact of higher charges for aeronautical services on passenger traffic, and hence on airports' non-aeronautical revenues, does not appear to be significant.*⁷

⁵ Productivity Commission, *Economic Regulation of Airport Services*, Productivity Commission Draft Report (August 2011) 43.

⁶ *Virgin Blue Airlines Pty Limited* (2006) ATPR 42-092, [512].

⁷ Productivity Commission, *Review of Price Regulation of Airports Services*, Report no 40 (14 December 2006) XVII.

Virgin Australia does not consider that developments since 2006 have altered the bases for these conclusions, eg during Global Financial Crisis (GFC), airports did not lower aeronautical charges in order to protect non-aeronautical revenue.

4 The value of benchmarking

The Commission has stated that:

[B]enchmarking studies suggest that, relative to their overseas counterparts, Australian airports have achieved:

- *relatively low aeronautical and non-aeronautical revenue per passenger*
- *relatively low total costs, operating costs and staff costs*
- *relatively high profits*
- *average to above average capital expenditure per passenger and return on capital employed.*

Taking all indicators into account, Australian airports appear to perform well relative to their overseas counterparts.⁸

Virgin Australia agrees that benchmarking measures should be adopted for use in assessing airport operating costs and charges so that trends can be monitored.

However, it has concerns about benchmarking analysis referred to by the Commission in its Draft Report to support the above conclusions. Indeed, the Commission has outlined in the Draft Report some of the 'numerous impediments' to effective benchmarking. The Commission has stated that these include differences across airports, data limitations and competing methodologies. Also as noted by the Commission, experiments with 'yardstick competition' for airports in a regulatory context have not been successful.

Virgin Australia is concerned therefore that the conclusion that 'taking all indicators into account, Australian airports appear to perform well relative to their overseas counterparts' could be an overstatement.

For example, the Commission has referred to a 2010 Airport Transport Research Society Global Benchmarking Report (**the ATRS Report**). The Commission does not explain how the airports were chosen by the ATRS as appropriate comparators for this exercise, making analysis of this data difficult. Virgin Australia is concerned that a simple comparison of the prices charged by the major Australian airports with airports overseas cannot be relied upon to provide any meaningful insights. The appropriate price for an airport's services is one that reflects the cost of providing that service, and this cost would be expected to vary significantly across airports.

In relation to the ATRS data regarding airport charges, it also appears that the ATRS Report focuses on international charges, not domestic charges. Virgin Australia's is concerned about all airport charges, but, overall, domestic charges have had the most impact on Virgin Australia's business. We also note that, from the ATRS report material provided by the Commission on airport charges, it appears that Sydney at least is charging significantly above the average of the sample group of overseas counterparts used (ie 57-69 per cent above the average).

⁸ Productivity Commission, *Economic Regulation of Airport Services*, Productivity Commission Draft Report (August 2011) 211.

The Commission has also referred to Jacob's Consultancy data to evidence that Australian airports fare well in terms of performance. Virgin Australia has only been able to review the Jacob's Consultancy data provided as part of the review process.

However, Virgin Australia notes that while the performance measures may provide an indication of the airports' overall economic performance as an investment, it does not provide conclusive evidence as to whether an airport, in the context of its own particular circumstances, is taking advantage of its monopoly power to earn monopoly rents. In relation to the data regarding returns on capital employed in particular, we note that this is an out of context assessment. To assess this, one would need to consider past expenditure and forecast future passenger demand.⁹

We also note that Commission has referred at several points to increasing levels of productivity at Australian airports.¹⁰ While Virgin Australia agrees that productivity is desirable, it notes that high productivity does not necessarily mean that airports are not making monopoly rents, and hence creating welfare losses. High productivity also does not demonstrate that airports' pricing conduct is in compliance with the *Aeronautical Pricing Principles*.

5 Airport investment and capacity

In the Draft Report, the Commission has made a number of draft findings regarding the level of investment at airports, ie that:

- investment has exceeded requirements established at the time airports were sold, and therefore levers available to the Government in relation to investment have not been triggered (Draft Finding 5.1); and
- there is evidence of significant investment in aeronautical infrastructure at Australian airports in the period since light handed monitoring was introduced, with significant future investment planned (Draft Finding 5.2).

Virgin Australia does not dispute that significant ongoing investment is required at airports to meet the future throughput demand of users.

However, the Commission's findings do not address Virgin Australia's concerns regarding the 'gold plating' of some airports through excessive rather than inadequate investment and the inefficient management of infrastructure projects to minimise time and expense.

Virgin Australia considers that this behaviour occurs at airports because airports can simply raise prices to cover the costs of the investments they make, regardless of whether the investments are warranted or efficiently carried out.

This can lead to inefficiently high costs which are borne, at least in part, by airlines to the detriment of consumers. Airports could not engage in this behaviour absent their market power.

Virgin Australia has provided some examples of this type of conduct in its 18 April 2011 submission at section 6.5(b), 6.5(c), and 6.5(h).

⁹ Assessment of expenditure is a complicated assessment. Expenditure (ahead of what is necessary) can inflate future returns, while delayed expenditure will transfer rent to an airport. Underinvestment will decrease the quality of service for the consumer.

¹⁰ For example, see the reference to the 2011 Assaf study: Productivity Commission, *Economic Regulation of Airport Services*, Productivity Commission Draft Report (August 2011) 217.

6 Airport charges as a proportion of airfares

The Commission has adopted data collected by BITRE to argue that airport charges as a proportion of airfares have remained low and relatively stable over the last five years. It has stated that the data suggests that even if increases in airport charges are passed on fully to customers, such increases are unlikely to significantly impact on the ticket prices paid by consumers, limiting any reduction in patronage (and associated welfare losses).¹¹

These conclusions are inconsistent with Virgin Australia's data as provided in its earlier submission at section 3.2 and as shown below. Virgin Australia considers that the difference may be due to a number of factors:

- Virgin Australia's data is based on the actual terminal and landing airport charges paid by it. The Commission's data appears to be based on airport public price schedules;
- Virgin Australia's data concerns its own fares only, while the Commission's data includes Qantas' fares which are, on average, much higher due to their greater proportion of the corporate traveller and higher fare business class fares; and
- Virgin Australia's data concerns average fares (ie the average of its own fares), while the Commission has used data concerning lowest available fares. If Virgin Australia were to examine its lowest available fares, airport charges would be an even higher proportion of its fares.

Virgin Australia considers that an approach that examines the average fare is more robust - the average fare being a point of consumer willingness to pay for a specific trip.

An examination of average fares also provides a better view of the true position regarding airport charges given the changes to the mix of fare types and pricing levels that occurs from year to year.

[CONFIDENTIAL]

Further, Virgin Australia notes that 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.

Table 1 below provides further evidence of increasing airport charges.

[CONFIDENTIAL]

¹¹ Productivity Commission, *Economic Regulation of Airport Services*, Productivity Commission Draft Report (August 2011) 65-68.

[CONFIDENTIAL]

Given the above, Virgin Australia maintains that airport charges are a very significant part of its cost base and make up a very significant proportion of its fares. Increases in airport charges have a significant impact on Virgin Australia's operations and Virgin Australia has no option but to pass on at least some of any increase to passengers, and this can have a significant impact on airfares and on passenger numbers, given the price sensitivity of many of Virgin Australia's passengers.

Increased airport charges cannot therefore be dismissed as merely rent transfers between airports and airlines. There are significant efficiency and welfare effects. The report from The Allen Consulting Group provided in 2006 by Virgin Australia on the behaviour of airports since removal of price control demonstrated that even a 25 per cent increase in the airport aeronautical charges at Sydney airport would result in hundreds of thousands of fewer passengers flying to or from Sydney every year.

7 Airport car parking and land access

In the Draft Report, the Commission has made draft findings and other comments regarding pricing and investment in relation to airport car parking and land access (see Draft Findings 8.1-8.4) which suggest that the Commission considers that there is little evidence of misuse of market power by the five monitored airports in terms of airport car parking and land access.

This is in contrast to the ACCC's findings in its *Airport Monitoring Report 2009-10*, which has identified a number of concerns regarding potential monopoly pricing of car parking and other land transportation services at monitored airports, particularly at Melbourne, Sydney and Brisbane airports.

Virgin Australia considers car parking to be a clear example of airports' unconstrained behaviour in charging high prices. In Virgin Australia's experience, airports often engage in monopoly pricing in relation to car parking fees and staff-car parking. Examples of inflated and unreasonable prices include the car parking fees at Melbourne Airport identified by the ACCC. For this reason, Virgin Australia considers price monitoring of these types of services to be important.

Virgin Australia has discussed the issue of car parking and land access in its 18 April 2011 submission at section 8. In that submission, it raised concerns that airports classify services as either aeronautical or non-aeronautical services to ensure maximum profitability, and that this results in inefficient pricing. Virgin Australia considers that the simplest and most effective way to remove inefficiencies associated

with this practice is to expand the current definition of aeronautical services to include everything within a terminal and all other services used by passengers in the course of travelling on airlines.

8 The inclusion of capital costs in price monitoring

The Commission has made the following information request:

The Commission seeks participants' views on the appropriateness of including capital cost, such as the cost of borrowing, in the ACCC's price monitoring program. Are there reliable measures that can be collected with relatively low compliance cost? If so, which is the best measure?

Virgin Australia considers that the Commission should monitor the capital cost covering the key items under the WACC which were detailed in its 18 April 2011 submission across the major airports. This contains items such as:

- debt margins, and how these are applied to long term pricing models and how variation in these affects pricing recovery;
- debt to equity ratios, and how well airports source investment capital and at what cost. Too much debt may mean that an airport may not have the public traffic to support its infrastructure investment. Too much equity may mean that airports are under investing in infrastructure to increase profit;
- funding horizons. Short term commercial loans and funding are often more expensive than long term loans and funding and reflect the investment communities confidence in the project;
- risk free rates, which Virgin Australia considers could be regulated or fixed;
- funding sources and foreign exchange. Virgin Australia also considers that it is unclear what the relevant reference rate is in the context of an international investment community where debt is sourced from both on-shore and off-shore markets;
- asset betas, and how these have been varied over time to increase WACC returns. Virgin Australia considers that a high beta (close to 1) is not applicable to airports because, unlike in relation to airlines, airports' results do not move relative to the overall market. This is demonstrated by the fact that during the GFC, airports' returns remained relatively insulated. Instead, Virgin Australia considers that asset betas could be agreed and fixed;
- gammas, and the definitional use of pre-tax and post-tax rates; and
- inflation, including an examination, over time, of the impact on fixed and variable airport costs. The application of an inflation rate may escalate a fixed price asset to inflate its value over time and increase the depreciation recovery beyond normal internal accounting practices. This may have the same effect of revaluing the asset every year and therefore increasing the total depreciation charge recovered.

The recovery of borrowing costs is relevant to the ability of an airport to source investment for its projects. For example, borrowing costs (ie holding costs), can increase significantly whilst airports take time to negotiate future price paths with airlines. Borrowing costs may also be minimised through timely Government and capital support. Incorrect or inefficient timing of capital applied to major infrastructure investments is always costly to someone in the value chain. As the industry is required to undertake a very high level of investment over the next ten years to support the consumer demand for air travel, better upfront consultation on these projects, and agreement with airlines in relation to

the recovery of funding, may overcome some of the challenges faced by airports in undertaking this investment. Virgin Australia suggests that the ACCC should review, as part of its monitoring function, at least the scope, timing and budget of major projects at each major airport.

Attachment A – Additional financial or other data to assist the ACCC in relation to a show cause process

The Commission has asked whether there are additional readily accessible financial or other data that would assist the ACCC to determine if a 'show cause' direction was warranted.

Virgin Australia considers that information on the revenue and expenses of airports' different aeronautical activities (separated into buckets that are meaningful, for example, aligning with the services that the landing and terminal charges apply to and removing costs that are recovered separately) would assist the ACCC to form a view about whether monopoly rents are being made.

The power to get behind the numbers and establish their validity would also assist the ACCC. This would include:

- reviewing how regulatory asset values have been updated over time, including a consideration of the accounting methodology used and starting values;
- reviewing the calculation of depreciation (and hence all of the inputs);
- commissioning an audit of annual revenue expenditure numbers;
- considering related party contracts (and the margins arising from those contracts);
- considering information on any one-off factors that may have affected expenses in a particular year;
- understanding costs allocation between aeronautical and non-aeronautical activities; and
- considering traffic volumes and information on one-off or unusual factors that may have affected traffic volumes in a particular year.

Ultimately, the amount of information required by the ACCC to make such an assessment would be much smaller than the amount required by the AER for energy networks, eg where it requests information to assist it to forecast future expenses.