APPLICATION BY VIRGIN BLUE FOR DECLARATION OF AIRSIDE SERVICES AT SYDNEY AIRPORT

FINAL RECOMMENDATION

National Competition Council

November 2003
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1 Recommendation

1.1 The Council’s recommendation is that the services the subject of Virgin Blue’s application for declaration, dated 1 October 2002, not be declared.

1.2 The service, defined as the Airside Service, is identified as:

the use of runways, taxiways, parking aprons and other associated facilities (Airside Facilities) necessary to allow aircraft carrying domestic passengers to:

(i) take off and land using the runways at Sydney Airport; and

(ii) move between the runways and the passenger terminals at Sydney Airport.

1.3 The Council’s decision not to declare the Airside Service follows from the Council’s conclusion that criteria (a) and (f) are not met.

1.4 The Council’s reasons for its recommendation are included in this document.

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Councillor David Crawford declared a conflict in this matter and did not take any part in the Council’s consideration and recommendation process.
### Abbreviations and Glossary of Terms

<table>
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<tr>
<th>Abbreviation</th>
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<tr>
<td>ACA</td>
<td>Airports Coordination Australia</td>
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<td>ACCC</td>
<td>Australian Competition and Consumer Commission</td>
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<td>ACTO</td>
<td>Australian Cargo Terminal Operators Pty Ltd</td>
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<tr>
<td>AIAL</td>
<td>Auckland International Airport Limited</td>
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| Airside Service | According to Virgin Blue’s application, the use of runways, taxiways, parking aprons and other associated facilities necessary to allow aircraft carrying domestic passengers to:  
- (i) take off and land using the runways at Sydney Airport; and  
- (ii) move between the runways and the passenger terminals at Sydney Airport. |
<p>| ATPR         | Australian Trade Practice Reports |
| BARA         | Board of Airline Representatives of Australia Inc |
| BTRE         | Bureau of Transport and Regional Economics |
| CBD          | Central business district |
| clause 6 principles | The principles contained in clause 6 of the Competition Principles Agreement (A substantive extract is set out in appendix B). |
| CoAG         | Council of Australian Governments |
| Commission   | Australian Competition and Consumer Commission |
| Council      | National Competition Council |
| CPA          | Competition Principles Agreement |
| DOTARS       | Department of Transport and Regional Services (Commonwealth) |</p>
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<thead>
<tr>
<th>Acronym</th>
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<tr>
<td>FAC</td>
<td>Federal Airports Corporation</td>
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<tr>
<td>Gas Code</td>
<td>The National Third Party Access Code for Natural Gas Pipeline Systems</td>
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<td>ICAO</td>
<td>International Civil Aviation Organisation</td>
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<td>MTOW</td>
<td>maximum take off weight</td>
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<td>NCP</td>
<td>National Competition Policy</td>
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<td>Part IIIA</td>
<td>Part IIIA of the <em>Trade Practices Act 1974</em></td>
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<td>Phase 1 airports</td>
<td>Airports leased to private operators in 1997 - Brisbane, Melbourne and Perth.</td>
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<tr>
<td>Phase 2 airports</td>
<td>Airports leased to private operators in 1998 - Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville, Mount Isa, Tennant Creek, Archerfield, Jandakot, Moorabbin and Parafield.</td>
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<td>PC</td>
<td>Productivity Commission</td>
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<td>PSA</td>
<td><em>Prices Surveillance Act 1983</em></td>
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<td>REX</td>
<td>Regional Express Airlines</td>
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<td>SAACL</td>
<td>Sydney Airports Corporation Limited</td>
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<td>SMS</td>
<td>Slot Management Scheme</td>
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<td>Sydney Airport decision</td>
<td>Re Review of declaration of freight handling services at Sydney International Airport (2000) ATPR ¶41–754</td>
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<tr>
<td>Terminal 2</td>
<td>Domestic Terminal at Sydney Airport used by Virgin Blue, Regional Express, Aeropelican, Horizon, Air Link and Qantas (flights QF1600 and above only)</td>
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<tr>
<td>TPA</td>
<td><em>Trade Practices Act 1974</em></td>
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<td>Tribunal</td>
<td>Australian Competition Tribunal</td>
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<td>Virgin Blue</td>
<td>Virgin Blue Airlines Pty Ltd</td>
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<td>WAC</td>
<td>Westralia Airports Corporation Pty Ltd, owner of Perth Airport</td>
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2 The national access regime

2.1 In April 1995, the Council of Australian Governments (CoAG) adopted the National Competition Policy reform package. Part IIIA of the TPA formed part of this package. It establishes a national access regime under which access seekers may gain a legal right to use the services of natural monopoly infrastructure. The rationale for providing access to such services is to promote competition in upstream and downstream markets.

2.2 Part IIIA sets out three pathways for access:

- **Declaration (and arbitration):** any person can apply to have a service ‘declared’. If declared, access seekers and providers have a right to binding arbitration by the Australian Competition and Consumer Commission (ACCC) if negotiations fail. Declaration is made for a specified period and does not give an access seeker exclusive rights to the declared service.

- **Certified (effective) regimes:** where an effective access regime already exists, declaration is not available and an access seeker must rely on the effective regime for access. A State or Territory access regime can be certified as effective if the regime meets the principles contained in clause 6 of the Competition Principles Agreement (CPA) (clause 6 principles).

- **Undertakings:** service providers can give an undertaking to the ACCC setting out access terms and conditions to their services. If accepted, the undertakings are legally binding and available to all access seekers.

Declaration process

2.3 Under the declaration pathway, a person wanting access to a particular service must apply to the Council to have the service declared. The Council considers the application before forwarding a recommendation to the designated Minister, who decides whether or not to declare the service. The State Premier or the Chief Minister of the Territory is the designated Minister where the provider in question is a State or Territory body and the State or Territory concerned is a party to the Competition Principles Agreement. In all other circumstances the designated Minister is the Commonwealth Minister (s. 44D(1)).
not to declare the service. The Minister’s decision is reviewable by the Australian Competition Tribunal (the Tribunal).

2.4 Declaration of a service does not provide the access seeker with an automatic right to use that service. Rather, as per Re Review of declaration of freight handling services at Sydney International Airport (2000) ATPR ¶41–754 (Sydney Airport decision), it:

   opens the door, but before an applicant to use the service can become entitled to use the service the applicant must progress to the second stage and either reach an agreement for access with the service provider or, in default of an agreement, have its request for access determined through an arbitration by the Australian Competition and Consumer Commission. (para 7)

2.5 While declaration in itself does not entitle the access seeker to access, it is an important step as it provides for an enforceable right to dispute resolution if negotiation fails. The ACCC as arbitrator, may, among other things, require the provision of access and specify the relevant terms and conditions. In reaching its determination, the ACCC must take into account the matters set out in s. 44X(1) of the TPA.

2.6 The ACCC’s determination is reviewable by the Tribunal.3

The declaration criteria

2.7 The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters, which are set out in s. 44G(2) of the TPA:

   (a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;

   (b) that it would be uneconomical for anyone to develop another facility to provide the service;

   (c) that the facility is of national significance, having regard to:

      (i) the size of the facility; or

      (ii) the importance of the facility to constitutional trade or commerce; or

      (iii) the importance of the facility to the national economy;

3 The declaration/arbitration process is set out in more detail in Appendix A.
(d) that access to the service can be provided without undue risk to human health or safety;

(e) that access to the service is not already the subject of an effective access regime; and

(f) that access (or increased access) to the service would not be contrary to the public interest.

2.8 The Council must also consider whether it would be economical for anyone to develop another facility that could provide part of the service: s. 44F(4).

2.9 In interpreting the declaration criteria, the Council uses general principles of statutory interpretation and accords primacy to the language of the declaration criteria. In addition, the Council has regard to the following matters:

- relevant decisions of the Federal Court of Australia;
- decisions of the Tribunal in relation to applications for coverage of gas pipelines for the purpose of the Gas Pipelines Access Law and the National Third Party Access Code for Natural Gas Pipeline Systems (the Gas Code);
- objectives underlying Part IIIA of the TPA having regard to the Hilmer Report (1993); and
- economic approaches to issues raised by previous applications considered by the Council for declaration and applications for coverage, and revocation of coverage, of gas pipelines by the Gas Code.

2.10 This final recommendation considers the criteria in a different order from that laid out in s. 44G(2) of the TPA. Conceptually, the Council considers it logical to begin with sub-section (b) (criterion (b)), because that criterion focuses on the issue of the service to which access is sought and the facility providing that service, and asks whether that facility exhibits natural monopoly characteristics. Sub-section (a) (criterion (a)) is wider in scope because it requires a consideration of industry structure, the related but distinct markets from the market for the service, and whether the service provider is able to exercise market power in those related markets. This approach is consistent with the Tribunal’s approach to the Duke Eastern Gas Pipeline Pty Ltd (2001) ATPR ¶41–821 (Duke EGP decision).
2.11 The process the Council adopts for considering the s. 44G(2) criteria can be broadly summarised as follows:

(a) Define the service provided by means of the infrastructure facility, delineate the physical assets that comprise the facility and identify the provider of the service.

(b) For the purposes of criterion (b), examine whether it is economic to develop another facility to provide the service. Declaration is confined to facilities exhibiting natural monopoly characteristics — that is, where it would be cheaper over a likely range of reasonably foreseeable demand for one facility to provide that service, rather than two or more facilities.

(c) For the purposes of criterion (a), assess whether declaration of the service would improve the conditions or environment for competition in a dependent market. Whether the conditions for competition would be enhanced depends critically on whether the natural monopoly characteristics associated with the provision of the service confer substantial market power on the service provider that can be exercised to adversely affect competition in a dependent market(s). As part of this evaluation, dependent markets need to be identified, as do factors affecting the ability and incentive to exercise market power to adversely affect competition in a dependent market(s).

(d) For the purposes of criterion (c), assess whether the facility is of national significance, having regard to the size of the facility, the importance of the facility to trade or commerce, or the importance of the facility to the national economy.

(e) For the purposes of criterion (d), assess whether access to the service can be provided safely.

(f) For the purposes of criterion (e), assess whether access to the service is already the subject of an effective access regime. A State or Territory access regime may, for example, be subject to a decision by the Commonwealth Minister under s. 44N of the TPA that the access regime is an effective access regime for the service, and the Council must
follow such a decision. Alternatively, there may be no State or Territory access regime in place that affects the service. In some instances, however, a State or Territory access regime that has not been certified as effective may exist and it will be necessary to assess the State or Territory access regime against the principles set out in the Competition Principles Agreement.

(g) For the purposes of criterion (f), determine whether access would not be contrary to the public interest. This criterion comes into play if the other criteria are satisfied. It enables a consideration of factors not raised under the other criteria — for example, the regulatory costs of providing access, and transitional pricing arrangements.


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4 The Council must follow the Minister’s decision unless there have been substantial modifications to the access regime or to the relevant principles set out in the Competition Principles Agreement (see s.44G(4) of the TPA).

3 Background to Sydney Airport access application

3.1 Sydney Airport is Australia’s largest and busiest airport. It is managed and operated by Sydney Airports Corporation Limited (SACL), formerly a corporatised Commonwealth entity. On 25 June 2002, the Commonwealth Government sold Sydney Airport to Southern Cross Airports Corporation, a consortium of companies sponsored by Macquarie Bank Ltd, HOCHTIEF AirPort GmbH and the Commonwealth Bank of Australia.

3.2 Virgin Blue began operations as a low-fare domestic carrier in Australia on 31 August 2000 at which time Qantas and Ansett were the incumbent domestic airlines. In September 2001, Ansett was placed in voluntary administration and in March 2002, it ceased operating. Since Ansett’s collapse, both Qantas and Virgin Blue have expanded their domestic capacity and the number of routes they service. Both airlines now currently service most major Australian domestic routes. Virgin Blue has also expanded its services to include a range of new offering such as airport lounges in major cities and more flexible ticketing arrangements.

3.3 On 1 October 2002, the Council received an application under Part IIIA of the Trade Practices Act 1974 (TPA) from Virgin Blue for a recommendation to declare the following services:

(a) the use of runways, taxiways, parking aprons and other associated facilities (Airside Facilities) necessary to allow aircraft carrying domestic passengers to:

(i) take off and land using the runways at Sydney Airport; and

(ii) move between the runways and the passenger terminals at Sydney Airport (Airside Service); and

(b) the use of domestic passenger terminals and related facilities for the purposes of processing arriving and departing domestic airline passengers and their baggage at Sydney Airport (Domestic Terminal Service).

3.4 On 26 November 2002, Virgin Blue wrote to the Council informing it that Virgin Blue and SACL had reached agreement on terminal
access. Virgin Blue foreshadowed that it would withdraw its application for declaration of Domestic Terminal Services once the parties entered into final documentation reflecting the agreement.

3.5 On this basis, in November 2002, the Council released an issues paper asking for public comment on matters arising from Virgin Blue’s application for the declaration of the Airside Service. A list of submissions received by the Council is set out in Appendix C.

3.6 Virgin Blue formally withdrew its application for declaration of the Domestic Terminal Service in December 2002.

Access regulation for airports

3.7 Prior to 6 September 2003, there were two separate legislative instruments providing for access to airports in Australia: an airports-specific instrument (s. 192 of the Airports Act 1996) and a general instrument (Part IIIA of the TPA). In addition, access arrangements for privatised airports are contained in the individual airport leases.

3.8 Section 192 of the Airports Act 1996 sets out an access regime for all privatised airports designated as core-regulated airports under the Act. Sydney Airport is designated a core-regulated airport under the Act (s. 7). It allowed airport operators 12 months, after an airport has been privatised, to seek ACCC approval for an access undertaking. If the ACCC did not approve the undertaking during this period, the provisions of s. 192 required the Minister to determine that each ‘airport service’ at the airport be a declared service for the purposes of Part IIIA of the TPA. An ‘airport service’ is defined in the Act to mean a service provided at a core regulated airport, where the service:

(a) is necessary for the purposes of operating and/or maintaining civil aviation services at the airport; and

(b) is provided by means of significant facilities at the airport, being facilities that cannot be economically duplicated;

and includes the use of those facilities for those purposes (s. 192(5)).

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6 A core regulated airport is defined in the Airports Act 1996 to mean Sydney (Kingsford-Smith), Sydney West, Melbourne (Tullamarine), Brisbane, Perth, Adelaide, Coolangatta, Hobart, Launceston, Alice Springs, Canberra, Darwin and Townsville airports, and an airport specified in the regulations, where the site of the airport is a Commonwealth place (s. 7).
3.9 In 2002 the Productivity Commission (PC) recommended that all airports be subject to the generic provisions of Part IIIA of the TPA rather than the airport specific access regime of s. 192 of the *Airports Act 1996* (PC 2002). The Commonwealth Government accepted this recommendation. Since 1 July 2002, anyone seeking regulated access to a particular service at a 'Phase 1 airport' has had to first apply to the Council for it to declare the service under Part IIIA of the TPA. On 1 July 2003, declaration under Part IIIA became available for services at Phase 2 airports.

3.10 Section 192 of the *Airports Act 1996* required the Minister to make a determination that airport services at Sydney Airport (being a core-regulated airport under the Act) be declared for the purposes of Part IIIA of the TPA. This was to occur as soon as practically possible after 1 July 2003 — 12 months after privatisation.

3.11 In light of the Government’s decision to accept the PC’s recommendation on airport regulation, the Government introduced amending legislation to repeal s. 192. On 1 July 2003 this amending bill had not yet been enacted. Consequently, the Minister made the mandatory determination that each ‘airport service’ at Sydney airport be a declared service for the purposes of Part IIIA of the TPA for a nominal period of 24 hours. The determination has now expired — section 192 no longer applies to Sydney Airport.

**Sydney Airport decision**

3.12 In November 1996, the Council received a number of applications from Australian Cargo Terminal Operators Pty Ltd (ACTO) for the declaration of:

- Federal Airports Corporation (FAC) services provided through facilities at Sydney International Airport;

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7 The Commonwealth Government used the term ‘Phase 1 airports’ to refer to those airports leased to private operators in 1997, that is, Brisbane, Melbourne and Perth (PC 2002, p. XIV).

8 Airports leased to private operators in 1998 — Adelaide, Alice Springs, Canberra, Coolangatta, Darwin, Hobart, Launceston, Townsville, Mount Isa, Tennant Creek, Archerfield, Jandakot, Moorabbin and Parafield.

9 The Civil Aviation Legislation Amendment Bill 2003, which repeals s. 192 was enacted on 6 September 2003.

10 Letters from The Hon. John Anderson MP, Deputy Prime Minister, Minister for Transport and Regional Services to Ms Wendy Craik, Acting President, National Competition Council, dated 19 July 2003.
• Qantas and Ansett services provided through facilities at Sydney and Melbourne International Airports.

The ACTO subsequently withdrew its applications for declaration of services provided by Qantas and Ansett.

3.13 In May 1997, the Council recommended the Minister declare the relevant FAC services. The Minister accepted the Council’s recommendation and subsequently declared the services. The FAC sought a review of the Minister’s decision in respect of the services provided at Sydney International Airport from the Australian Competition Tribunal. On 1 March 2000, the Tribunal made the Sydney Airport decision to uphold the Minister’s declaration of FAC services at Sydney International Airport. Specifically, the Tribunal:

(a) declared the service provided by the use of the freight and passenger aprons and the hard stands at Sydney International Airport for the purpose of enabling ramp handlers to load freight from loading equipment onto international aircraft and to unload freight from international aircraft onto unloading equipment; and

(b) declared the service provided by the use of an area at Sydney International Airport for the purpose of enabling ramp handlers:

(i) to store equipment used to load and unload international aircraft; and

(ii) to transfer freight from trucks to unloading equipment and to transfer freight from unloading equipment to trucks, at the airport.

3.14 Declaration of these services commenced on 1 March 2000 and will expire on 28 February 2005.

Declaration available notwithstanding access

3.15 A number of submissions the Council received in response to its issues paper noted that Virgin Blue already has access to the Airside Service and that Sydney Airport is not able to deny access to the service.

3.16 Existing access to a service is no bar to a consideration of whether that service should be declared (Sydney Airport decision, para 229).
Declaration is available where existing or new users are permitted access to the service, and seek the right to:

(a) additional access beyond that presently permitted; and/or

(b) access on more efficient terms and conditions than those offered by the service provider.\textsuperscript{11}

\textsuperscript{11} Existing contracts continue to operate even if a service is declared.
4 Defining the service, the facility and identifying the provider

The service

Background

4.1 Section 44B defines the types of services that are declarable under Part IIIA as follows:

‘service’ means a service provided by means of a facility and includes:

(a) the use of an infrastructure facility such as a road or railway line;

(b) handling or transporting things such as goods or people;

(c) a communications service or similar service;

but does not include:

(d) the supply of goods; or

(e) the use of intellectual property; or

(f) the use of a production process;

except to the extent that it is an integral but subsidiary part of the service.

4.2 The declaration process in Part IIIA provides for access to the services of a facility (or part of a facility), rather than the facility itself. A service is something separate and distinct from a facility. It may involve merely the use of a facility.

4.3 For the purposes of Part IIIA, the relevant service is that which is bought and sold, or for which there are potential transactions. The way in which a service is defined must be commercially meaningful.

4.4 It may be necessary in characterising the service provided by means of a facility to specify the purpose for which access to the service is
sought. In particular, it may be necessary to incorporate the purpose for which the service is provided, to ensure the right to negotiate access to the service following declaration is suitably limited by a reference to purpose. Further, incorporating the purpose of the service provision in the delineation of that service may help define the relevant upstream and downstream markets for the assessment of criterion (a).\textsuperscript{12}

**The application**

4.5 Virgin Blue seeks declaration of the ‘service for the use of runways, taxiways, parking aprons and other associated facilities necessary to allow aircraft carrying domestic passengers to:

(i) take off and land using the runways at Sydney Airport; and

(ii) move between the runways and the passenger terminals at Sydney Airport.’ (Virgin Blue 2002, p. 6)

4.6 These are collectively referred to as the Airside Service.

**Assessment**

4.7 The Council notes that the description of Airside Service refers to both the use of certain facilities and the purpose for which that use will be put without reference to a specific end-user. The Council considers this approach to be consistent with that taken by the Tribunal in the Sydney Airport decision. In that case, the Tribunal concluded that the relevant service provided by SACL was the making available of the freight aprons, hard stands and other areas to enable other persons carrying on other activities (namely, the loading and unloading of aircraft and the transfer of freight from the loading and unloading equipment to and from trucks) to provide their own services. (Sydney Airport decision, para 16)

4.8 The Council notes that the description of the Airside Service includes the use of the term ‘other associated facilities’. SACL submitted that:

\textit{the term ‘other associated facilities’ is far too broad and is likely to lead to confusion and dispute over the types of facilities covered by the application. It is essential that the terms of any declaration that may be made should allow no room for subsequent debate as}

\textsuperscript{12} See Sydney Airport decision and Duke EGP decision.
to the extent of, or limitations on, the resultant jurisdiction of the ACCC in the event of any access dispute. (SACL 2003a, p. 7)

4.9 In its issues paper, the Council asked for views as to whether the facilities referred to in the definition of Airside Service should be specifically described, and if so, what assets should be taken to make up the relevant facility.

4.10 Virgin Blue considered that it was not necessary to specifically describe the facilities necessary to provide the service and that at a minimum, the facilities would include the following:

- the runways at Sydney Airport;
- the taxiways at Sydney Airport;
- the parking aprons at Sydney Airport;
- airfield lighting;
- airside roadways;
- airside lighting; and
- visual navigation aids. (Virgin Blue 2003a, p. 3)

4.11 Virgin Blue went on to note that it ‘...does not consider that this is an exhaustive list of the facilities required to provide the Airside Service and ... that the facilities required to provide the Airside Service may change over time’ (Virgin Blue 2003a, p. 3).

4.12 BARA submitted that the term ‘airside service’ is an ambiguously defined term in the airline industry but that the term ‘airside’ has a generally accepted and understood meaning (BARA 2003a, p. 3). The International Civil Aviation Organisation (ICAO) defines ‘airside’ as: ‘the movement area of an aerodrome, adjacent terrain and buildings or portions thereof, access to which is controlled.’ Given the ICAO definition, BARA considers it reasonable to conclude that Airside Service refers to the activities associated with the access, movement and servicing (refuelling, catering and cleaning) of an aircraft within the airside precinct (BARA 2003a, p. 4).

4.13 The ACCC, in its Draft Guide to Section 192 of the Airports Act 1996 defined ‘airport services’ as services ‘provided by airside facilities’. It defined ‘airside facilities’ in the following terms:

Airside facilities include aircraft movement areas such as runways, taxiways and aprons, aircraft parking areas, safety devices and guidance systems, airfield and airside lighting,
airside grounds associated with the use of these facilities and vehicular access to these facilities. (ACCC 1998, p. 23)

The ACCC further noted that these assets ‘directly relate to the functions of an airport’ (ACCC 1998, p. 23). Without these assets it would be impossible for civil aviation services to be undertaken at an airport.

4.14 In its report on the price regulation of airport services, the PC (2002) divided the functions of an airport into different services based on the facilities used to provide the service (the PC adopted this method based on information received in submissions from the Department of Transport and Regional Services (DOTARS) and the ACCC). One such set of facilities was ‘aircraft movement facilities’, which comprised: ‘runways, taxiways, aprons and aircraft parking, as well as airside grounds, airfield lighting, airside roads and lighting, airside safety, nose-in guidance, and visual navigation aids’ (PC 2002, p. 146). The PC grouped these assets together in this category because it considered the assets essential to the operation of an airport.

4.15 BARA considered Virgin Blue’s approach to defining the Airside Service to be appropriate. BARA noted that the approach is consistent with the definitions of ‘aeronautical services’ and ‘aeronautical related services’ as generally understood within the industry, adopted by DOTARS in its Pricing Policy Paper (Nov 1996), Direction no. 27 of the Treasurer dated 26 June 2002 and by the ACCC in its quality of service indicators report (BARA 2003c, p. 3).

4.16 A number of submissions considered that it is not necessary for the Council to comprehensively define the Airside Service. Virgin Blue stated that it:

\[\textit{does not believe that it is practicable or helpful to the analysis of the Airside Service to provide a comprehensive and definitive list of the assets currently used to provide the Airside Service.} \] (Virgin Blue 2003a, p. 4)

4.17 Melbourne Airport stated that:

\[\textit{Whilst we accept the need for precision in service definition, the Council should not get distracted by the definition of “other associated facilities”. In many cases such as runway and taxiway lights, navigation aids, airfield directional signage, movement surface markings and so on, associated facilities could be argued as being integral if not to the primary facilities (runways, taxiways etc) then certainly to the services provided by them.} \] (Melbourne Airport 2003, p. 4)
4.18 BARA submitted that ‘further detailed submissions on the particular services is not likely to advance the issue at this stage’ (BARA 2003c, p. 2).

4.19 The Council considers that there is little to be gained from attempting to specify all the assets that make up the relevant facility. While the Council acknowledges that a consideration of relevant facilities may be necessary to define the service, its task is to determine whether a particular service, not a facility, should be declared under Part IIIA. The issue of what specific assets are required to provide the declared service is a matter the ACCC would need to consider were the matter to go to arbitration.

4.20 In support of this, the Council notes the Sydney Airport decision, where the Tribunal stated:

Part IIIA of the Act sets out the statutory scheme which provides a role for the Council, the Minister, the Tribunal, the Commission and the Federal Court of Australia. It is part of the statutory scheme, where in certain circumstances an applicant cannot gain access to a service, that a process can be commenced which may result in the Commission arbitrating an access dispute. At that stage, the provider of the service has full opportunity to make such submissions it wishes to the Commission as it is a party to the arbitration of the access dispute: s 44U. As we have noted earlier, in making a determination in any such arbitrated access dispute the Commission must take into account the matters set out in s 44X(1). These matters include, inter alia, the interests of all persons who have a right to use the service, the operational and technical requirements necessary for the safe and reliable operation of the facility and the economically efficient operation of the facility. (para 221)

4.21 In supplementary submissions BARA and Virgin Blue sought to include use of the Airside Service by international aircraft. BARA stated that Virgin Blue’s application ‘and any consequent declarations, should not be confined to services for aircraft carrying domestic passengers but also international passengers’. BARA reasoned that ‘generally, services for aircraft, whether domestic or international, involve the whole of Sydney Airport (as the relevant facility)’ (BARA 2003b, p. 1).

4.22 Virgin Blue supports this approach stating that:

there is no reason why the Airside Service should be limited to the use of facilities by aircraft carrying domestic passengers ... Therefore, Virgin Blue considers that the Council should consider recommending the declaration of a service which is not limited to aircraft carrying domestic passengers. (Virgin Blue 2003a, p. 4)
4.23 The Council has scope to amend the definition of the service that is the subject of an application to ensure that the service description is appropriate. In this case, the Council considers that broadening the definition of Airside Service to encompass international aircraft is a significant departure from the definition put forward by Virgin Blue in its original application. The Council therefore advised both BARA and Virgin Blue that it would not broaden the definition of Airside Service to include international aircraft in the absence of a formal amendment to Virgin Blue’s application. Virgin Blue has not sought such an amendment.

Conclusion

4.24 The Council considers that the definition of Airside Service proposed by Virgin Blue is broadly consistent with service groupings adopted by the Productivity Commission, the ACCC and submissions from interested parties received by the Council. The Council considers the definition of Airside Service put forward by Virgin Blue to be appropriate for the purpose of considering its application for declaration.

The facility providing the service

Background

4.25 The declaration criteria in s. 44G(2)(b) and (c) and the definition of service in s. 44B refer to the facility that provides the service (the subject of the declaration application). Accordingly, the Council must determine what facility provides the Airside Service in order to determine whether s. 44G(b) — the natural monopoly test — and (c) — the national significance test — are satisfied. The term ‘facility’ is not defined in the TPA, although the s. 44B definition of ‘service’ cites examples, including roads and railway lines.

4.26 In the Sydney Airport decision, the Tribunal stated that ‘a facility for the purposes of the Act is a physical asset (or set of assets) essential for service provision’ (para 82). The relevant facility is therefore comprised of ‘the minimum bundle of assets required to provide the relevant services subject to declaration’ (para 192).
The identification of the bundle of assets will have an impact on the assessment of the application under s. 44G(2)(b). As noted by the Tribunal in the Sydney Airport decision:

*The more comprehensive the definition of the set of physical assets ... the less likely it is that anyone ... would find it economical to develop “another facility” within a meaningful time scale. Conversely, the narrower the definition of facility, the lower the investment hurdle and inhibition on development.* (para 192)

The Tribunal considered ‘the complete suite of physical assets necessary to service international airlines flying into and out of the Sydney region’. It found that most (if not the whole) of the airport, including ‘all the basic airside infrastructure, such as the runways, taxiways and terminals and related land-side facilities [were] integral to the effective functioning of air-side services’. The Tribunal considered that this suite of assets, which it described ‘in practical terms’ as ‘the whole of the airport’ was necessary for international aircraft to land at Sydney Airport, load and unload passengers and freight, and depart, and essential to the services to which access was sought. The Tribunal concluded that the whole of the airport constituted the relevant facility within the meaning of Part IIIA (Sydney Airport decision, para 99).

The reference in the Sydney Airport decision to the relevant facility amounting to the ‘whole of the airport’ does not mean that an access seeker could get access to each and every asset making up the whole of the airport. Rather, it is the service and not the relevant facility that is declared. The relevant facility is delineated for the purposes of determining whether the declaration application satisfies the natural monopoly test in criterion (b) and the national significance test in criterion (c).

**The application**

In its application, Virgin Blue submitted that the relevant facility that provides the Airside Service is ‘the whole of Sydney Airport’. This is due to the ‘highly interconnected or bundled nature of domestic air passenger transport operations at Sydney Airport’ (Virgin Blue 2002, p. 8).
Assessment

Sydney Airport decision

4.31 Virgin Blue has relied on the Sydney Airport decision as authority for the proposition that the relevant facility for the provision of the Airside Service is the whole of Sydney Airport. Virgin Blue has proposed that the relevant facility for the provision of the Airside Service should comprise essentially the same minimum bundle of assets as in the Sydney Airport decision; that is, ‘the minimum set of physical assets necessary for ... aircraft to land at [Sydney Airport], unload and load passengers and freight and depart’ (para 99). This, in practical terms, amounted to the whole of the airport.

4.32 The Sydney Airport decision was about the facilities needed to operate international air freight services. In contrast, Virgin Blue’s application relates to domestic passenger and freight operations. Accordingly, it does not necessarily follow that the minimum bundle of assets required in the Sydney Airport decision are the same as those required to provide the Airside Service.

Submissions

4.33 Virgin Blue reiterated its position that the relevant facility is the whole of Sydney Airport. It stated that:

Virgin Blue accepts that there may be some areas that form part of Sydney Airport that may not be necessary for the provision of the Airside Service. However, Virgin Blue does not consider that it would assist in the analysis of criteria (b) or (c) under section 44G(2) of the Act to attempt to identify those particular parts of Sydney Airport and the circumstances in which they may not be necessary for the provision of the Airside Service. Virgin Blue notes that the Tribunal in Re Sydney International Airport did not attempt to engage in such a review of potentially unnecessary parts of Sydney Airport. (Virgin Blue 2003a, p. 5)

4.34 SACL considered that defining the relevant facility as being the ‘whole of Sydney Airport’ was far too broad. SACL stated that it:

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13 The service subject to the declaration application was (1) the service provided through the use of the freight aprons and hard stands to load and unload international aircraft at Sydney International Airport and (2) the service provided by the use of an area at Sydney International Airport to: store equipment used to load/unload international aircraft; and to transfer freight from the loading/unloading equipment to/from trucks at the airport (Sydney Airport decision, para 17).
Does not believe that the application, nor the nature of airport facilities, supports the conclusion that the minimum bundle of airport services is the whole of Sydney Airport. While this conclusion was reached by the Australian Competition Tribunal in the ACTO case, we do not consider it to be the appropriate conclusion in the case of the Virgin Blue application. (SACL 2003a, p. 7)

SACL’s argued that a number of assets making up Sydney Airport (namely, aircraft parking aprons and terminal facilities) can be economically developed and that it is inappropriate to include such assets in the definition of the relevant ‘facility’ for the purposes of criteria (b) and (c).

4.35 The Council does not accept SACL’s approach. The question that needs to be asked to determine the relevant facility is: what is the minimum bundle of assets required to provide the service? It may well be that certain specific assets making up that minimum bundle do not exhibit natural monopoly characteristics or satisfy the national significance test. That does not preclude those assets from falling within the minimum bundle making up the relevant facility. In considering the natural monopoly criterion (criterion (b)) and the national significance criterion (criterion (c)), it is necessary to consider the facility as a whole.

4.36 The Council notes that s. 44F(4) requires the Council to ‘consider whether it would be economical for anyone to develop another facility that could provide part of the service.’ This inquiry is distinct from the preliminary issue of determining the relevant minimum assets required to provide the service. Section 44F(4) relates to the assessment of criterion (b) and is considered in more detail in paragraphs 11.7 to 11.9.

4.37 In their respective submissions Melbourne Airport (2003a), Adelaide and Parafields Airports (2003a), WAC (2003) and BARA (2003a) listed specific assets they considered would be required to provide the Airside Service. While the respective lists vary in their degree of specificity, the lists were principally based on those applied by the ACCC, the Treasurer (see Direction no. 27) and DOTARS in defining aeronautical services and other similar service groupings.

4.38 The Council considers that the lists of assets put forward in these submissions provide guidance as to the specific assets required to provide the Airside Service rather than attempting to define the ‘facility’ for the purposes of criteria (b) and (c). In other words, the
specific assets set out in these lists may be the types of assets required for access to the Airside Service under Part IIIA.

4.39 Indeed, the Council considers that the comprehensive lists provided in the submissions add weight to the argument that a multitude of highly interconnected assets are required to provide the Airside Service, and that, as such, the relevant facility is in practical terms, the whole of Sydney Airport as concluded by the Tribunal in the Sydney Airport decision.

Conclusion

4.40 The Council considers that the whole of Sydney Airport is the relevant facility for the purposes of criteria (b) and (c).

Provider of the service

Background

4.41 Part IIIA refers to the provider of an infrastructure service in a number of contexts; namely:

(a) when an application for declaration is received, the Council must inform the provider;

(b) if the Minister declares the service, then the provider may apply to the Tribunal for review of the decision; and

(c) the provider is required to negotiate access if a service is declared, and may be bound by the ACCC’s arbitration of an access dispute.

4.42 Section 44B of the TPA provides the following definition:

‘provider’, in relation to a service, means the entity that is the owner or operator of the facility that is used (or to be used) to provide the service.

4.43 In effect, the provider is the entity that controls the use of a facility and has the legal power to determine whether — and on what terms — access is provided. The provider must therefore be capable of negotiating access with an access seeker or, if negotiation fails, being
bound by an arbitration determination. There can only be a single provider of each relevant service (see s. 44B, TPA).

The application

4.44 Virgin Blue identified SACL as the provider of the Airside Service.

Assessment

4.45 SACL owns and operates Sydney Airport. The Council formally notified SACL of receipt of Virgin Blue’s application pursuant to s. 44F(2)(a).

4.46 The Council notes that SACL does not provide all assets at Sydney Airport. In particular, Qantas currently leases from SACL the land on which the Qantas Terminal is situated together with land adjacent to the terminal to enable further expansion (Domestic Terminal Lease). The Domestic Terminal Lease was entered into in 1987 and will expire in 2017. Qantas also has long term leases with SACL for exclusive use of a number of other areas within Sydney Airport including the land on which its Jet Base and Hanger 96 are situated. Qantas owns all improvements to the leased land including the terminal building, Jet Base and Hanger 96. Qantas has exclusive rights of use to the leased land.

4.47 Under the terms of its leases, there is nothing preventing Qantas from granting and negotiating terms of access to its terminal and other assets situated on leased SACL land. In contrast, during the term of the leases, SACL is not entitled to grant and negotiate terms of access to the land covered by the leases. For this reason, the Council considers that Qantas, and not SACL, is the provider of services requiring access to the Qantas Terminal and other Qantas owned assets situated on land leased from SACL on a long term exclusive use basis.

4.48 As there can only be one provider of the service subject to the declaration application, a successful application will enable access seekers to seek access to the service provided only by that entity identified in the declaration determination as the service provider. In the case of the Airside Service, that service provider is SACL.
Conclusion

4.49 The Council considers that Sydney Airports Corporation Ltd is the relevant provider of the Airside Service because it is the operator of Sydney Airport.
5 Uneconomical to develop another facility

s. 44G(2)(b) It would be uneconomical for anyone to develop another facility to provide the service.

Background

5.1 The Council cannot recommend that a service be declared unless it is satisfied that it would be uneconomical for anyone to develop another facility to provide the service (s. 44G(2)(b)) (criterion (b)).

5.2 The Tribunal in the Sydney Airport decision recognised that the declaration criteria are essentially intended to limit declaration to services provided by a facility that:

- exhibits natural monopoly characteristics — that is, one firm can meet the entire range of relevant demand at a lower cost than two or more firms; and

- creates a bottleneck — that is, access to the facility is essential for competition in any dependent market(s) (para 82).

5.3 Criterion (b) tests whether a facility exhibits natural monopoly characteristics. (Criterion (a) addresses whether a facility that exhibits natural monopoly characteristics is also a bottleneck or essential facility). Criterion (b) is concerned with the nature of the facility rather than with the competitive impact of the service provided by means of the facility.

Uneconomical

5.4 The term ‘uneconomical’ introduces a natural monopoly test to criterion (b). The Tribunal articulated this test in the Duke EGP decision:

[the] test is whether for a likely range of reasonably foreseeable demand for the services provided by means of the pipeline, it would be more efficient, in terms of costs and benefits to the community as a whole, for one pipeline to provide those services rather than more than one. (para 137)
5.5 In other words, a facility is a natural monopoly for the purposes of criterion (b) where it can serve the entire range of reasonably foreseeable demand for the service provided by the facility at lower cost than that of two or more facilities.

5.6 Application of this natural monopoly test therefore requires the Council to:

(a) determine the reasonably foreseeable demand for the service provided by the facility; and

(b) assess whether the facility can serve the range of reasonably foreseeable demand for the service at lower cost than that of two or more facilities.

Develop another facility

5.7 In assessing whether it is uneconomical to ‘develop’ another facility, it is appropriate to consider facilities that have already been developed (Duke EGP decision, para 57).

5.8 The term ‘develop’ is sufficiently broad to encompass modifications or enhancements to existing facilities. If another facility exists, but does not provide the services subject to declaration, but could economically be modified or expanded to do so, then criterion (b) is not met.

5.9 A facility can exhibit natural monopoly characteristics whether or not it is the only facility providing the service. The Council must consider any other existing facility for the criterion (b) assessment in two situations.

5.10 The first is where the facility would be unable to serve the reasonably foreseeable demand for that service without some modification or augmentation. In these circumstances, if the additional demand for the service could be served at lower cost by modification or augmentation of another existing facility rather than by modification or augmentation of the facility currently providing the service subject to declaration, then criterion (b) is not met.
5.11 Second, the existence of another facility that provides the service will be relevant to the identification of the reasonably foreseeable range of demand for that service, as required for the criterion (b) test. In these circumstances, the reasonably foreseeable demand for the service can be determined from both:

(a) the reasonably foreseeable level of output that the facility subject to the application would be likely to serve; and

(b) the reasonably foreseeable level of output that other facilities would be likely to serve.

Time horizon for assessment

5.12 Consideration of whether it would be uneconomical for someone to develop another facility to provide the service has temporal elements. The Council recognises that a conclusion that it would be uneconomical for anyone to develop another facility to provide the service may change over time as a result of changes in demand and changes in supply conditions, such as technological change.\(^{14}\)

5.13 The Council may elect not to recommend declaration of the service if, as a result of foreseeable changes in demand and supply conditions, criterion (b) would no longer be satisfied during the time horizon for the criterion (b) assessment.

The application

5.14 The Council considers that the relevant facility to be considered in the assessment of criterion (b) is the whole of Sydney Airport (see paragraphs 4.25 to 4.40).

5.15 Virgin Blue submitted that Sydney Airport is uneconomic to ‘duplicate.’\(^{15}\) In support of this submission, Virgin Blue notes:

(a) both the Council and the Tribunal have found that it is uneconomic for Sydney Airport to be duplicated;

(b) the Commission’s Draft Guide to Section 192 concludes that most larger airports, and possibly all core regulated airports, could not be economically duplicated; and

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\(^{14}\) Similarly, the applicability of the other declaration criteria to a particular service may change over time.

\(^{15}\) The Council has interpreted Virgin Blue’s reference in its application to ‘uneconomic to duplicate’ to be a reference to ‘uneconomic to develop’ as used in criterion (b).
(c) Sydney Airport is the busiest airport in Australia, processing over 14.8 million domestic (including regional) passengers annually and 208,086 domestic (including regional) aircraft movements each year. It operates 3 runways and covers a total of 2,369 hectares. It clearly exhibits significant economies of scale and very substantial entry and exit costs. (Virgin Blue 2002, pp. 9-10)

5.16 Virgin Blue submitted that there is no substitute for the Airside Service, as Sydney Airport is currently the only airport that offers services allowing for the landing or taking off of aircraft in Sydney that are suitable for a regular domestic air passenger transport service. While there are other airports located within the Sydney metropolitan area, Virgin Blue submitted that even the largest of these, Bankstown Airport, is not a substitute for Sydney Airport as a supplier of domestic air passenger transport services to or from Sydney because:

(a) Bankstown Airport cannot provide services allowing for the landing or taking off of aircraft of a size equivalent to a Boeing 737 or larger. Aircraft smaller than a Boeing 737 are not suitable for use on many domestic passenger routes due to higher costs of operation (on a per passenger basis) or because they lack the necessary range.

(b) Bankstown airport does not offer the same suite of services that are offered at Sydney Airport, such as interconnection with other airlines. In this regard Virgin Blue notes the Tribunal’s comments in the Sydney Airport decision:

[M]any airports also benefit from economies of scale and scope generated by strong network effects associated with their geographical location and the absence of viable alternative transport modes. Passengers typically travel to destinations, not airports, and airlines will prefer to locate at one airport so that they may gain commercial benefits from interconnecting with other services and airlines (para 85); and

(c) demand from consumers of domestic air passenger transport services for flights from Bankstown Airport is likely to be very low due to:

(i) Bankstown Airport being located significantly farther from the Sydney central business district than Sydney Airport; and

(ii) a lack of facilities at Bankstown Airport, including a lack of interconnection with other airlines. (Virgin Blue 2002, pp. 7-8)
Assessment

Sydney Airport decision

5.17 As noted above at paragraph 4.40, the Council considers the relevant facility is Sydney Airport as a whole. This is the same relevant facility the Tribunal considered in the Sydney Airport decision. For this reason, the Council gives considerable weight to the reasoning and conclusions of the Tribunal in the Sydney Airport decision on whether Sydney Airport satisfies criterion (b).

5.18 The PC in its report on price regulation of airport services noted that major Australian airports display the following natural monopoly characteristics (PC 2002):

- an indivisibility of investment – whereby the cost of establishing facilities at new airports is higher than the cost of expansion at existing airports (p. 99);
- economies of scale (p. 101);
- high sunk costs (pp. 101-102);
- economies of scope (pp. 102-3); and
- network benefits (pp. 104-5).

5.19 The Tribunal concluded in the Sydney Airport decision that most airports demonstrate natural monopoly characteristics. The Tribunal stated:

Once the basic infrastructure (runways, taxiways, control tower) is in place, the owner of the facility faces sharply falling costs of servicing increments of demand (economies of scale). By contrast, a new entrant would have to replicate this basic infrastructure which is inherently capital intensive. Such airports also typically provide a bundle of services, (for example, international and domestic passenger and freight services). In addition, many airports also benefit from economies of scale and scope generated by strong network effects associated with their geographical location and the absence of viable alternative transport modes. Passengers typically travel to destinations, not airports, and airlines will prefer to locate at one airport so that they may gain commercial benefits from interconnecting with other services and airlines. (para 84-85)
5.20 The Tribunal went on to conclude that:

*Sydney International Airport* exhibits very strong bottleneck characteristics:

- Not only is it Sydney's only international airport, it is Australia's major international airport, handling some 50% of international airfreight leaving and entering Australia;
- it handles the largest portion of total international passenger traffic entering and leaving Australia;
- it is a national and regional inter-connector with domestic passengers travelling overseas, with the two domestic carriers (Qantas and Ansett) having invested very large sums in their passenger handling facilities. (para 86)

5.21 Consequently, the Tribunal concluded that Sydney International Airport, as a whole was a natural monopoly. In particular, the Council notes the following conclusion of the Tribunal:

*Given the Tribunal’s findings in relation to the definition of facility, would it be uneconomical for anyone to develop another facility to provide the service? The answer to this question is clearly, “yes”. This is because the very powerful economies of scale and scope of [Sydney Airport] discussed above preclude anyone, even the incumbent owner and operator, from developing another facility offering the physical infrastructure and the associated rich inheritance of market attributes at [Sydney Airport].* (para 202)

5.22 It should be noted that the Tribunal’s definition of Sydney International Airport (para 38-43) included domestic passenger and freight facilities.

5.23 Given the conclusion in the Sydney Airport decision that at the time of the hearing in 1998, Sydney Airport was a natural monopoly, the Council’s approach to criterion (b) in the case of Virgin Blue’s application is to focus in particular on developments since the decision to determine whether Sydney Airport no longer exhibits natural monopoly characteristics. In particular, the Council considered information relating to the likelihood of any capacity constraint taking into account foreseeable demand for the Airside Service and how such capacity constraint would be managed.

**Foreseeable demand for the Airside Service**

5.24 As noted above at paragraph 5.6, assessments of the reasonably foreseeable demand for the service and whether the facility can serve
the forecast demand are relevant to determining whether the facility is a natural monopoly.

5.25 In the case of demand at Sydney Airport, DOTARS (1999) estimates that annual passenger traffic at the airport is expected to increase to 35 million in 2009-10 and 49 million in 2021-22 and aircraft movement is expected to grow to 381,000 in 2009-10 and 480,000 in 2021-22. Assuming current trends in aircraft size and loading continue, it estimates that Sydney Airport will reach capacity in 2006-07, when demand is forecast to be 31 million passengers per year. Alternatively, if it were assumed that, in the longer term, regional passengers would be carried in larger aircraft, allowing more room for domestic and international services, capacity would be reached in 2010-11, when demand is forecast to be 36 million passengers (DOTARS 1999).

5.26 SACL estimates that annual passenger traffic through Sydney Airport will increase from 26.4 million in 2000-01 to 68.3 million in 2023-24, of which 38 million will be domestic, and annual freight traffic will increase from 430,000 tonnes to 1.297 million tonnes in that same period. SACL also forecasts for the next ten year period an annual average increase in passenger traffic of 4.2 per cent and aircraft movements of 2.4 per cent. SACL expects that within the next ten years, aircraft movements will return to the level experienced at Sydney Airport in early 2001 (SACL 2003e).

5.27 SACL notes that its primary capacity constraint is the restriction imposed by the _Sydney Airport Demand Management Act 1997_ of 80 aircraft movements an hour. In relation to slot capacity, SACL notes that prior to 11 September 2001, Sydney Airport was slot constrained in the morning peak between 7am and 9am. The airport is not currently slot constrained although SACL anticipates that capacity constraints during peak times will again occur sometime between 2009 and 2014 (SACL 2003c).

5.28 SACL released its draft ‘Master Plan’ in July 2003. The Master Plan is a 20 year plan for the future development of Sydney Airport, which takes into account the future needs of airport users and developmental objectives. SACL must submit its final Master Plan to the Minister for Transport and Regional Services by 31 December 2003.

5.29 SACL’s draft Master Plan notes that it is ‘not necessary to build new runways or lengthen the exiting runways over the next 20 years’ and that ‘the existing runway infrastructure is adequate to support the forecast air traffic for the next 20 years’ (SACL 2003e, p. 7).
Currently no airport, other than Sydney Airport, provides the Airside Service. As noted at paragraph 5.16, Virgin Blue submitted that Bankstown Airport (the largest of Sydney’s secondary airports) is currently unable to provide services allowing for the landing or taking off of aircraft of a size equivalent to a Boeing 737 or larger which are necessary for the effective operation of a national domestic network. This view is supported by the findings of DOTARS, which concluded that ‘Bankstown is not capable of handling major jet services’ (DOTARS 1999). This means that it is not necessary for the Council to look wider than Sydney Airport to identify the reasonably foreseeable demand for the Airside Service.

A number of the submissions received by the Council considered whether the prospect of a second Sydney airport and/or the development of Bankstown Airport impacted on whether Sydney Airport was a natural monopoly. As noted in paragraph 5.10, it is only relevant to consider other facilities that may be developed to provide the Airside Service if Sydney Airport will not be able to meet the foreseeable demand for the service without augmentation. On the basis of SACIL’s demand forecasts, the Council considers that Sydney Airport will not require augmentation to meet the reasonably foreseeable demand for the Airside Service. It is therefore not relevant for the Council to consider the development of other facilities.

Relevant developments since the Sydney Airport matter hearing

In its issues paper, the Council sought views as to whether there were any developments in the aviation and airports sectors since the Sydney Airport decision that may lead to the conclusion that Sydney Airport no longer exhibits natural monopoly characteristics. The Council received no submissions suggesting that such developments had occurred.

Frontier Economics, which was commissioned by Virgin Blue, stated that:

*we know of no evidence that market conditions have changed in any significant way in the last few years so as to change that assessment. Consequently we consider, consistent with the Tribunal’s view expressed in its Sydney International Airport decision, that Sydney Airport has strong natural monopoly characteristics.* (Frontier Economics 2003a, p. 6)
5.34 In its submission, Virgin Blue noted that it:

> does not consider that there has been any development in the aviation or airport sector since the decision in Re Sydney International Airport, nor any other reason that might lead to the conclusion that:

- *Sydney Airport no longer exhibits natural monopoly characteristics; or*

- *that it would be economic to develop another such airport.*

(Virgin Blue 2003a, p. 7)

5.35 The Council considers there to have been no developments since the hearing of the Sydney Airport matter that may lead to the conclusion that Sydney Airport no longer exhibits natural monopoly characteristics.

**Conclusion**

5.36 The Council has considered the reasoning and conclusions of the Tribunal in the Sydney Airport matter together with developments in the aviation and airports sectors since the hearing of the Sydney Airport matter to determine whether Sydney Airport is a natural monopoly.

5.37 On the basis of SACL’s demand projections, and the absence of capacity constraints at Sydney Airport in the short to medium term, the Council considers that Sydney Airport continues to be a natural monopoly. The Council therefore concludes that Virgin Blue’s application satisfies s. 44G(2)(b).
6 Promoting competition in another market

s. 44G(2)(a) Access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service.

Background

6.1 The purpose of section 44G(2)(a) (criterion (a)) is to limit access regulation to circumstances where access is likely to enhance the environment for competition in a dependent market(s). Whether competition will be enhanced depends critically on the extent to which the incumbent service provider can, in the absence of access regulation, use market power to adversely affect competition in a dependent market. If the service provider has the ability and incentive to use its market power to adversely affect competition in a dependent market, regulated access may improve the environment for competition, offering the prospect of tangible benefits to consumers, including reduced prices and better service provision.

6.2 According to Ordover and Lehr (2001), a service provider has three avenues for seeking to use its monopoly power to adversely affect competition in the dependent market(s):

(a) the service provider may impose terms and conditions that result in the extraction of monopoly returns, such as the charging of monopoly prices, for the provision of the service subject to declaration;

(b) the service provider may engage in explicit or implicit price collusion; and/or

(c) the service provider may engage in strategic behaviour designed to leverage its monopoly power into the dependent market(s) in order to advantage a vertically related affiliate.

In relation to this third limb, the Council also considers that it is possible that a monopoly service provider may exercise market power by leveraging its monopoly power into the dependent market in order
to advantage a non-affiliated entity with which it has an arrangement designed to facilitate such leveraging, and to realise some of the gains from such a strategy. Whether a service provider engages in such conduct depends on it having both the ability and the incentive to do so.

6.3 The service provider may not have the ability and incentive to exercise market power to adversely effect competition in the dependent market(s) where:

(a) the facility does not occupy a bottleneck position in the supply chain for the service;

(b) the service provider is constrained from exercising market power in the dependent market(s). The service provider’s ability to exercise market power may be constrained by competitive conditions in the dependent market(s) and/or the market power of other participants in the market(s); or

(c) the incentives faced by the service provider are such that its optimal strategy is to exercise market power to pro-competitively effect competition in the dependent market(s). For example, in certain circumstances, it may be profit maximising for a service provider to promote increased competition in the dependent market(s) and maximise demand for the services provided by the facility.

6.4 If it is established that the service provider has the ability and incentive to exercise market power to adversely affect competition in the dependent market, the Council considers that in the absence of significant structural impediments to the promotion of competition in the dependent market (for example, where the dependent market is itself characterised by a natural monopoly), declaration will promote competition and criterion (a) will be satisfied.

The application

6.5 Virgin Blue submitted that access (or increased access) to the Airside Service would promote competition in, at least, the market in which domestic (both interstate and intrastate) air passenger transport services are supplied to and from Sydney (Sydney Domestic Market). Virgin Blue argued that:

*Given that the Airside Service is a necessary input for the provision of domestic air passenger transport services in the*
Sydney Domestic Market, and therefore that no provider of domestic air passenger transport services could compete in the Sydney Domestic Market without access to this Service, Virgin Blue considers that access (or increased access) to the Airside Service would promote competition in at least the Sydney Domestic Market. Virgin Blue (2002, p. 7)

6.6 In response to the Council's initial assessment of this matter in its issues paper, Virgin Blue, on advice from Frontier Economics, subsequently amended the definition of the Sydney Domestic Market to include both passenger and freight (Virgin Blue 2003a).

6.7 In its submission, Virgin Blue (2003a) considered that much of its argument applied equally to international services, raising the possibility that declaration of the Airside Service may also promote competition in the market in which aircraft carrying international passengers to and from Sydney operate.

Assessment

Defining the relevant dependent markets

General

6.8 For the purpose of criterion (a), the Council needs to be satisfied as to the existence of ‘at least one market ... other than the market for the service’ (the subject of the declaration application) in which competition would be promoted.

6.9 Market definition is required for the application of criterion (a), both:

• to identify relevant distinct markets from the market for the service; and

• to facilitate an assessment of the competition effects of declaration in those distinct markets, including consideration of the related question of whether the terms of supply of the service are constrained by substitution in those distinct but related markets.

6.10 ‘Market’ is defined in section 4E of the TPA as:

For the purposes of this Act, unless the contrary intention appears, “market” means a market in Australia and, when used in relation
to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first-mentioned goods or services.

6.11 In considering the question of market definition, the Council is guided by the work of the ACCC (in particular, the Merger Guidelines: ACCC 1999), the Tribunal and the Courts in their consideration of market definition for the purposes of Part IV, as well as the Tribunal’s and the Court’s consideration of market definition in the context of Part IIIA.

6.12 The Tribunal has defined ‘market’ in the following way:

A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them (if there is no close competition there is of course a monopolistic market). Within the bounds of a market there is substitution - substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive. ... Whether such substitution is feasible or likely depends [on a number of factors/ ... in determining the outer boundaries of the market we ask a quite simple but fundamental question: If the firm were to ‘give less and charge more’ would there be, to put the matter colloquially, much of a reaction? (Re Queensland Co-operative Milling Association Ltd (1976) 25 FLR 169 at 190)

6.13 This view of market has been accepted by the High Court in a number of decisions (see in particular Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Ltd and Another (1989) 167 CLR 177 (Queensland Wire) and applied by the Tribunal in the context of Part IIIA (see the Sydney Airport decision and the Duke EGP decision).

Market definition as a tool

6.14 It is clear jurisprudence that market definition is a tool to be used in the determination of the particular issue at hand. The Full Federal Court in Queensland Wire noted that:

In our view, in defining the market or markets involved in a particular dispute, one should begin with the problem at hand and ask what identification of market best assists in analysing the processes of competition, or lack of competition, with which the case is concerned. ((1987) 78 ALR 407 at 415; (1988) ATPR 40-841 at 49,074-49,075)
6.15 It has also been expressly recognised that ‘[t]he linking together of the process of definition of the market and its object implies some flexibility in the former’ (Australian Meat Holdings Pty Limited v TPC (1989) ATPR 40-932 at 50,104). This link was also referred to in that case as being ‘interactive’. Accordingly, there is some flexibility in concluding different market definitions for different applications such as merger cases, predatory pricing cases and for application under Part IIIA.

6.16 It follows from this analysis that in determining the appropriate market definition for the purpose of Virgin Blue’s application, the Council must keep in mind the purpose for which that definition will be put; namely, to assess whether declaration of the Airside Service at Sydney Airport will make a difference to competition in that dependent market.

6.17 This means that while the market definitions applied by the ACCC or other competition regulators in the context of international airline alliance cases or anti-competitive conduct proceedings may be of assistance to the Council, they may not be directly relevant. The purposes for which markets are defined in those cases are different from the purpose for which the Council is required to define dependent markets; namely, to determine whether criterion (a) is satisfied.

Submissions

6.18 As noted above at paragraph 6.5, Virgin Blue submitted that the relevant dependent markets for the purposes of criterion (a) are the market in which domestic (both interstate and intrastate) air passenger transport services are supplied to and from Sydney (Sydney Domestic Market), and possibly the market in which aircraft carrying international passengers to and from Sydney operate. For clarity, Virgin Blue amended the definition of the Sydney Domestic Market to include both passenger and freight in response to the Council’s issues paper and the views of Frontier Economics. (Virgin Blue 2003a, p. 8)

6.19 SACL agreed with Virgin Blue’s original approach to market definition although considered that domestic (interstate) and regional (intrastate) air transport services belong in separate markets. This is because New South Wales regional air services to and from Sydney Airport have particular regulatory protections such as slot entitlements and a degree of price control that non-regional
domestic services do not have. SACL does not expressly state whether it considers freight services to fall within the same market as passenger services although it argues against the inclusion of freight facilities in Virgin Blue’s application which did not originally refer to freight (SACL 2003a, pp. 3, 8).

6.20 No other submission received expressly considered how the relevant dependent market(s) should be defined for the purposes of criterion (a) although BARA appeared to support the possibility raised by Virgin Blue that declaration of the Airside Service may promote competition in the market in which aircraft carrying international passengers to and from Sydney operate.

6.21 No submission supported the Council’s preliminary view, as expressed in its issues paper, that the relevant dependent markets may be defined on the basis of specific point-of-origin to point-of-destination routes and possibly by way of passenger type, fare class and non-air travel options.

Product market dimension

6.22 Markets are analysed by reference to their dimensions; that is, product, functional, geographic and temporal. Each of these dimensions is considered below. In the case of Virgin Blue’s application the most significant issues arise in respect of the product and geographic dimensions of the market.

Passenger types and fare classes

6.23 In its issues paper, the Council raised the possibility that different markets may exist for different passenger types such as leisure and business passengers and different fare classes such as business, fully flexible economy and discount.

6.24 Such an approach was adopted by the ACCC in its authorisation of the British Airways/Qantas Restated Joint Services Agreement in 2000. The ACCC stated that:

The demand characteristics of economy passengers are perceived as heavily price orientated. On the other hand, quality of service, almost regardless of price, seems to be the focus for premium passengers.

Under these circumstances it would be difficult to argue that there is a high degree of substitutability between economy and premium class air transport. (ACCC 2000, pp. 49, 50)
6.25 The ACCC re-affirmed this view in its recent final authorisation determination on the proposed Qantas/Air New Zealand alliance. The ACCC noted that the fact that business travellers fly economy on Virgin Blue is not inconsistent with its position that there can be different demand elasticities for different types of travellers (ACCC 2003). The ACCC also noted that airlines may have already recognised the distinction between:

leisure travellers and business travellers in the way that fares and conditions of travel are structured. The typical business traveller requires flexibility, short stay, and short lead booking times. Premium class satisfies all these requirements, but at a relatively fixed price. At the economy class level, low fares are associated with conditions such as advance purchase, no flexibility and no refunds. These conditions effectively restrict access to the business traveller to those fares. Even if the business traveller can plan a trip in advance to meet these requirements, minimum stopover conditions, in many cases will, rule out that fare. (ACCC 2003, p. 68)

6.26 The ACCC concluded that, taking into account factors such as the effect of loyalty programs, corporate travel contracts and the existence of a highly specialised business travel agency industry, the ‘Commission is increasingly of the view that there are separate markets for business and leisure travellers’ (ACCC 2003, p. 69).

6.27 Such an approach has also been adopted by the European Commission in airline alliance matters which considers time-sensitive and ‘non-time sensitive’ passengers to constitute different markets.

6.28 The Productivity Commission in its inquiry into international services also concluded that business and leisure passenger groups have distinct demand characteristics (PC 1998).

6.29 The Council did not receive any submission which supported the view that the relevant dependent market for the purpose of Virgin Blue’s application should be delineated on the basis of passenger type or fare class.

\[\text{16} \]
6.30 There is evidence that different passenger types have, in broad terms, different demand characteristics. As noted by the ACCC and the PC above, different passenger types have different price elasticities and product quality requirements. Such demand characteristics may vary between routes. In its submission, BARA noted that on shorter haul routes 'airlines generally face lower yields and higher price elasticity of demand' and that on long haul international routes, airlines offer a broader range of product types and service than on shorter haul routes (BARA 2003a, p. 5).

6.31 The conclusions of the ACCC and the PC set out above relate to international services. Demand characteristics of passengers on international services, particularly long haul services such as those considered by the ACCC in the British Airways/Qantas matter, may be significantly different to those of passengers on domestic services. The Council has no clear evidence on this point.

6.32 For different passenger types to constitute different markets it is necessary to consider whether passengers can be identified or grouped such that market boundaries can be drawn on the basis of their distinct demand characteristics. This is problematic in the case of domestic air passenger services.

6.33 In discussions with the Council, Virgin Blue argued that it is not possible to clearly differentiate between groups of passengers based on their demand characteristics. Virgin Blue argued that there is a spectrum of demand characteristics with some characteristics being more important to certain passengers than others. For example, the degree to which business passengers are more price inelastic and require fully flexible travel options may vary for each business passenger to such a point that the most price elastic business passenger may display similar demand characteristics to non-business travellers.

6.34 This point was also made by NECG on behalf of Qantas in the Qantas/Air New Zealand alliance authorisation matter. NECG noted that there is a continuum along which passenger demand characteristics vary such that it is not possible to divide passengers and demand characteristics into clear groups that delineate a market product boundary. For example, at one extreme, passengers may be less price sensitive and rate premium products/fares, flexibility, need for frequencies and frequent flyer/lounge access programmes highly.

accessed at:
http://europa.eu.int/comm/competition/mergers/cases/decisions/m2041_en.pdf.
At the other end of the spectrum, the opposite may be the case (NECG 2002).

6.35 In considering the degree of supply side substitutability, the Council notes that airlines determine the product mix such as the number of business, fully flexible economy, discount and other economy cabin products for each route as part of their yield management process. Yield management is an ongoing process and airlines readily change the composition of product offerings on a particular service or route in line with yield management objectives.

6.36 While different passengers have different demand characteristics particularly in relation to price and quality of service on domestic flights, such differences are not so distinct so as to be able to delineate separate product markets on the basis of passenger type. In addition, there is a significant degree of supply side substitutability in terms of product offerings as part of the yield management systems of airlines. While the ACCC has concluded that in relation to international air services, separate markets based on passenger type do exist, the Council does not have sufficient evidence to identify separate markets for domestic air services.

6.37 The Council considers it appropriate to assess Virgin Blue's application on the basis of a broader market product dimension that includes all passenger types.

Intermodal substitution

6.38 A further matter raised in the Council's issues paper was whether air travel was substitutable with other modes of transport such as road, rail and sea. The PC (2002) concluded that the greater the distance and the more time-sensitive the passenger, the lower the possibility that land and sea forms of transport would be considered as substitutes for air services.

6.39 There may be a sufficiently high degree of inter-modal substitution to conclude that on specific routes, particularly short-haul regional routes such as from Sydney to Newcastle, the relevant market when considering that route in isolation is the market for passenger transport rather than air passenger transport services. However, for the reasons set out in paragraph 6.79, the Council considers that the appropriate geographic dimension for the relevant dependent market is the national domestic market as a whole. Taking all domestic routes and all passenger types and classes as a whole, the Council considers there to be insufficient inter-modal substitution for the
market to be characterised as anything other than an air transport services market.

**Freight and passenger products**

6.40 Virgin Blue submitted that the dependent market includes both passenger and freight air transport services (Virgin Blue 2003a).

6.41 From the demand perspective, there is no substitututability between passenger and freight air services. They are clearly distinct products.

6.42 On the supply side, Frontier Economics (2003a, p. 16) argued that ‘there are clear interdependencies and synergies in the production of, and competition for, the provision of the cluster of products or services’ (that is, passenger and freight air transport services).

6.43 Frontier Economics went on to argue that in the case of Virgin Blue’s application:

\[
\text{...one might consider what range of activities an airline would take into account when deciding whether to run another route into and out of Sydney. The revenue that would be relevant to such a question would be the sum of revenue from passenger services and revenue from freight.}
\]

*It may be argued that the mere existence of dedicated air-freight carriers may be evidence that the synergies between carriage of passengers and freight may not be important and therefore may provide constraints to behaviour. However, the published data all suggest that dedicated freight carriers account for 10 to 15 per cent of all freight that is carried.* (Frontier Economics 2003a, p. 16)

6.44 On this basis, Frontier Economics (2003a, p. 17) concluded that ‘there are strong complementarities’ in the production of passenger and freight air transport services such that they should be included in the same dependent market.

6.45 The ACCC, in its Ansett Australia alliance authorisation determination, and the PC, in its inquiry into International Air Services, noted that dedicated air freight carriers constituted about 10 per cent of total air freight transported with the remainder being transported in passenger aircraft holds (ACCC 1998; PC 1998). This figure, however, relates to international freight services. In the absence of specific figures for domestic freight services, the Council accepts on the basis of submissions received that the proportion of domestic air freight carried by dedicated freight carriers is small with the remainder being carried by domestic passenger aircraft.
6.46 In the proposed Qantas/Air New Zealand alliance considered for authorisation by the ACCC and the NZ Commerce Commission, Qantas submitted a report from NECG that concluded that there is a product market for domestic (and international) air freight that is separate to the passenger market (NECG 2002).

6.47 In the same matter, Virgin Blue submitted evidence from Frontier Economics rejecting this view on the basis that the NECG view focused too much on demand side considerations and ignored the commercial reality of how airlines operate (Frontier Economics 2003b). Frontier Economics (2003b) argued that scheduling, capacity, pricing and investment decisions of airlines take into account both freight and passenger operations so that the market should be characterised as a single cluster market encompassing both passenger and freight services.

6.48 In response to these arguments the ACCC concluded, in the Qantas/Air NZ alliance authorisation matter, that notwithstanding evidence of complementarities, passenger and freight services constitute different markets. The ACCC (2003, p. 69) stated that:

The Commission is not persuaded by the argument of Virgin Blue that there should be a single market for freight and passengers. While it is true that the predominance of air cargo is carried in the holds of passenger aircraft, the aircraft selection practices of airlines and differing characteristics of the carried product (freight versus passenger) are indicative of separate markets.

It is the Commission’s understanding that airlines make decisions on where to operate services and the type of aircraft to be operated based on passenger traffic considerations. While cargo revenue is welcomed, it is supplementary. This is most evident in the stated intention of Air NZ to replace wide body 767 capacity on the Tasman with narrow body A320 capacity with or without the Proposed Arrangements. Given the severe limitations of narrow body aircraft as movers of freight (relative to wide body aircraft) Air NZ’s decision is obviously a decision made from the perspective of passenger traffic.

A corollary of this is that the decision to move to narrow-bodied aircraft is unlikely to have an air transport supply side impact on passengers but it certainly will have one for freight, especially in the trans-Tasman market. In other markets, depending on the circumstances, there may be economies of joint production in respect of the provision of passenger and freight services.

6.49 In response to the Council’s specific questions in relation to freight services, Virgin Blue noted that its freight services are not integrated with its passenger services, except to the extent that
passengers and freight are carried on the same flights.’ Further, that ‘Virgin Blue’s operational decisions such as flight scheduling are based almost entirely on passenger requirements, and freight is very much a secondary consideration.’ It also noted that almost all costs of freight carriage are common to passenger services and are not allocated to freight services (Virgin Blue 2003d, pp. 1-2).

6.50 Both Regional Express (REX) and Aeropelican Air Services, a small regional operator of services between Sydney and Newcastle, supported this view of freight as a secondary service to passenger services. REX (2003, p. 1) noted that ‘[O]perational decisions such as scheduling are determined primarily on passenger requirements, with freight requirements being secondary’. Aeropelican advised that its operational decisions were totally uninfluenced by its freight operations; freight took last priority on a flight following the loading of passenger baggage.

6.51 Both Virgin Blue and REX noted that an airline offering passenger services would nearly always offer freight services. This was because freight provided supplementary revenue through the use of space left over in the aircraft hold. The incremental cost of providing freight services is low and the service is administratively simple to provide (REX 2003; Virgin Blue 2003c).

6.52 In considering whether freight and passenger services should be included within the same dependent market, the Council considers two distinct issues. The first is the extent (if any) to which the complementarities in production between freight and passenger services are such as to conclude they form a cluster market. This requires a consideration of whether the cluster market approach is acceptable jurisprudence in Australia. The second issue is to what extent (if any) there is supply side substitutability between the production of freight and passenger services so as to warrant a conclusion that they fall within the same market.

6.53 In relation to the cluster markets issue, the Council notes the view of Shiff et al that ‘cluster markets arise when unbundled supply is impossible or (more usually) uncompetitive because of economies of scope which may arise in either demand or supply’ (Shiff et al 1998, p. 3). To date, courts have accepted the existence of a cluster market where distinct, but complementary, products are sold as a package because it is cheaper and more convenient for consumers to purchase the package as a whole rather than the products separately. The approach has been extensively applied in US anti-trust cases,
principally involving financial services and health care industries\(^\text{18}\) (Shiff et al. 1998). In Australia, no court has accepted the cluster market approach, although the ACCC applied it in relation to the merger of Westpac and Challenge banks (ACCC 1996).

6.54 The Council does not accept that freight and passenger services constitute a cluster market. The products are not sold as a package and airlines do not compete on the sale of the products as a package. In addition, there is real doubt as to whether current Australian jurisprudence accepts a market definition based on the cluster market approach. For these reasons, the Council rejects the argument that freight and passenger services should be included in the same market on the basis that they form a cluster of products.

6.55 The Council now considers whether there is sufficient supply side substitutability between freight and passenger services to warrant their inclusion within the same market. As noted in paragraph 6.12, it is accepted jurisprudence that substitutability on both the demand and supply side needs to be taken into account in defining the boundaries of the market. The Court and the Tribunal has considered the issue of complementary products and supply side substitutability on a number of occasions. In *Re Tooth & Co Ltd; Re Tooheys Ltd* (1978) ATPR 40-113 (at 18, 198), the Tribunal held that the relevant product market included both bulk and packaged beer because producers had a significant degree of flexibility in shifting their output between the two products.

6.56 In *Regents Pty Ltd v Subaru (Aust) Pty Ltd* (1989) ATPR 41-647 (at 41, 182), the Court found that the relevant market was for ‘the supply of motor vehicles, parts and ancillary services’ because the supplier was able to change the mix of products (vehicle types) in response to market pressures.

6.57 In *Australian Competition and Consumer Commission v Boral Ltd* (2001) 106 FCR 328, Finkelstein J noted that ‘[G]roups of firms making non-substitutable goods may be competitors if they employ similar skills and equipment and could easily move to other product lines if conditions become favourable’ (at 303–304). His Honour went on to stress the view that ‘the Court should consider actual patterns of market behaviour’ (at 318) and that:

\(^{18}\) See, for example, United States v Philadelphia National Bank, 418 US 565 (1973); United States v Central State Bank, 1989 1 Trade Cases, Trade Regulation Reports, 68, 493; Santa Cruz Medical Clinic v Dominican Santa Cruz Hospital 1995-2 Trade Cases, Trade Regulation Reports, 71, 254; Rozema v Marshfield Clinic & Sec Health Plan of Wisconsin Inc, 1997-2 Trade Cases, Trade Regulation Reports 71, 939.
if products are in the same market one would expect to find that over a period of time the price movement of each product would correlate. When price movements do not correlate the chance of the products being in the same market is not great. (at 320)

6.58 The case extracts set out above highlight the key point that for products to fall within the same market, there must be a relationship between the products such that a change in demand conditions for one product has an effect on the other. In other words, there must be a sufficient degree of cross-elasticity of supply between the products.

6.59 In response to questions from the Council on the extent to which (if any) such relationship existed, Virgin Blue noted that aside from the initial fit out of an aircraft, ‘[u]nless the aircraft is specifically designed to be reconfigured it is a very expensive and lengthy process to reconfigure an aircraft to carry more/less cargo/passenger space’ (Virgin Blue 2003c, p. 3). As such, aircraft space dedicated to passenger and freight services on individual aircraft remains unchanged regardless of movements in demand conditions for either product.

6.60 The Council notes DOTARS’ view that as most air freight is carried in the holds of passenger aircraft, the main driver for the supply of air freight capacity is the demand for passenger services rather than the demand from freight. This means that developments in the passenger airline industry have a direct effect on air freight services (DOTARS 2002b). Airlines provided evidence that support this view. As set out above at paragraphs 6.49 and 6.50 airlines base their operational decisions almost entirely on conditions in the passenger market with minimal regard to conditions in the air freight market.

6.61 As a result, a change in the market conditions for passenger services may impact on freight but not the other way around. For example, an increase in demand for passenger services on a particular route may lead to airlines increasing frequencies on the route. This would add air freight capacity and may result in prices for air freight services falling. In contrast, an airline would be unlikely to increase frequencies on a route in response to an increase in demand for freight services alone. This means that a change in demand conditions for air freight would have little (if any) impact on the market for passenger services.

6.62 While the Council recognises that there are complementarities in joint production of freight and passenger air services such that the same service providers supply them using the same assets, it does not consider this relationship to mean that the products fall within
the same market. In coming to this view, the Council notes the total absence of any demand side substitutability between the products. Similarly there is an absence of requisite supply side substitutability. While conditions in the passenger market may affect the supply of freight services, conditions in the freight market have little (if any) impact on the supply of passenger services. In other words, freight services are an adjunct to but have no effect on the provision of passenger services. For these reasons, the Council considers that passenger and freight air services fall into distinct product markets.

Geographic dimension

6.63 Three alternative views were put forward as to the appropriate geographic dimension of the relevant dependent market(s), namely:

- at its narrowest, based on city pairs, as discussed in the Council’s issues paper;
- a market for air services supplied to and from Sydney, which Virgin Blue advocates; or
- a market for air services supplied to and from Sydney, but with domestic (interstate) and regional (intrastate) services belonging in separate markets, which SACL advocates.

6.64 The city pair market definition approach (that is, one based on specific point-of-origin to point-of-destination routes) is based on a consideration of demand side substitution possibilities between city pair routes. Overseas jurisprudence and regulatory approaches to market definition in the airline industry support such an approach.19 In his submission, Professor Forsyth adopted a city pairs approach for his analysis in conformity with international practice, but noted it did not affect the arguments presented. Australian practice, however, has largely focused on demand side substitutability possibilities.

6.65 Airlines have largely acknowledged that there is a limited degree of demand side substitutability between city pair routes. In its submission to the PC inquiry on price regulation of airport services, Qantas stated that ‘[f]rom a demand perspective, air transportation

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19 See, for example, Canada (DIR) v Air Canada (1993) 49 CPR (3d) 7 at 60, BA/American Airlines, Lufthansa/United Airlines and KLM/Alitalia/Delta alliance European Commission and US authority determinations.
to a capital city is not substitutable for an alternative capital city.’
Virgin Blue submitted to the inquiry that ‘[d]emand for travel to a
particular destination is largely inelastic’ (PC 2002, pp. 110–12).

6.66 Notwithstanding the limited degree of demand side substitutability
between city pair routes, the city pair approach to defining the
relevant market was rejected in most submissions that considered
the matter. The arguments in support of wider market definitions
principally relied on:

- a consideration of supply side substitutability possibilities and
route complementarities; and

- practical considerations in facilitating the Council’s
  consideration of criterion (a).

6.67 Frontier Economics stated that:

_In summary, defining separate markets for each city pair leads to
two problems. First, it makes no economic sense to analyse_ competition on one city pair independently of that of any other if
there are strong complementarities in flying one city pair and
another. If there are strong complementarities in supply, airlines
that fly multiple city-pairs will have a strong competitive
advantage over a hypothetical airline that attempted to specialise
in only one city-pair. Secondly, it will lead to a costly duplication
of words because the NCC will need to analyse the effect of the
proposed declaration on each city pair. The most appropriate way
to think of the market that is likely to be affected by declaration is
the market for air services to and from Sydney._ (Frontier
Economics 2003a, p. 18)

6.68 SACL submitted that:

_While the market for domestic (interstate) services could
theoretically be split into market segments such as city pair,
business/leisure passengers. Such segregation is of more relevance
to an airline in its operations than to the use of an airport by
aircraft. SACL does not differentiate between domestic services
based on origin or destination, nor on the type of passenger catered
for by the service. Accordingly, SACL suggests that an attempt to
further disaggregate the logical market definitions of domestic and
regional services would increase the complexity of assessment of
the application without yielding practical benefits._ (SACL 2003a,
p. 3)

6.69 On the issue of supply side substitution and complementarities
between routes, Frontier Economics noted that ‘[d]ifferent city pairs
are linked together in markets because of complementarities in demand and in production.’ They went on to note that:

If an aircraft flies from Brisbane to Sydney and then flies on from Sydney to Melbourne (and flies north on the return journey) it makes little sense to say that the airline is transferring capital equipment from one market to another. For this reason, it is a standard precept when defining markets to link together products between which there is a high cross elasticity of supply. If aircraft can be switched from one city pair to another, it is appropriate to define a market that embraces both city pairs. (Frontier Economics 2003a, pp. 17-18)

6.70 Virgin Blue advised the Council that there is sufficient supply side substitutability to warrant a market definition broader than the city pair approach. It argued that aircraft could be easily moved between one route and another in response to changes in price, demand and profitability. Virgin Blue added that it has had little cause to significantly alter its schedule other than to add flights due to the airline’s rate of growth. If, however, growth was to stabilise, ‘then Virgin Blue may have to consider the redeployment of aircraft throughout its network’ (Virgin Blue 2003c, p. 5).

6.71 REX noted that:

On the Rex network such redeployments are limited, due to the nature of our route structure and size of the markets we serve. Nevertheless redeployments do occur, mostly in times of peak demand. Impediments include aircraft and crew availability, CASA issues such as route endorsements for crew and competing demands within our network. (REX 2003, p. 1)

6.72 Such evidence suggests that there are few limits to supply side substitution possibilities between routes in the medium to long term as it is feasible to redeploy aircraft between routes in response to changes in price, demand and profitability. The Council also notes the findings of DOTARS that ‘[c]hanges in the number of available seats on the top 20 competitive routes were broadly in line with movements in passenger activity between 2000-01 and 2001-02 years’. This also indicates there is supply side substitutability between routes, at least, over the medium term (DOTARS 2002, p. vi).

6.73 Virgin Blue noted that a specific aircraft is limited to certain routes by its configuration as well as by the distances for which it is certified to fly. Virgin Blue added that its fleet is made up of Boeing 737s. The fleet is divided into high gross weight 737s that have been configured and certified to fly long haul flights (up to 6 hours) and
low gross weight 737s, which have been certified and configured to operate on short haul flights (less than 3 hours). It costs approximately $4 million more to configure and certify a high gross weight 737 than a low gross weight 737 (Virgin Blue 2003c). Virgin Blue noted that:

Accordingly, while Virgin Blue's ability to redeploy an aircraft throughout its network may be limited to some extent by the distance for which that aircraft is certified to fly, Virgin Blue does not consider this limitation to be overly significant. A low gross weight 737 cannot fly a long haul route and it may be inefficient to use a high gross weight 737 on short haul routes. (Virgin Blue 2003c, p. 6)

### 6.74
While this may suggest a break in supply side substitutability between long haul and shorter haul routes, comments received on this issue suggest the limitation is not significant. Hurdles to substitution relate to cost — it is expensive and inconvenient to reconfigure and recertify aircraft and inefficiencies result from operating long haul aircraft over short haul distances — but there appears to no technological constraints to supply side substitution. The Council, therefore, does not consider that the geographic dimension of the market should be delineated on the basis of long haul and short haul routes.

### 6.75
As noted above at paragraph 6.5, Virgin Blue submitted that the geographic dimension of the relevant dependent market (that is, the Sydney Domestic Market) is air services supplied to and from Sydney. Virgin Blue, supported by Frontier Economics, argued that ‘little is gained’ by extending the analysis to activities outside routes to and from Sydney. This was despite its argument that significant supply side substitutability and complementarities between routes warrant a broadening of the Council’s preliminary city pair market approach (Virgin Blue 2002, p. 7; Frontier Economics 2003a, pp. 18–19).

### 6.76
Frontier Economics argued that limiting the definition of the relevant dependent market to routes into and out of Sydney was appropriate to the Council’s consideration of SACL’s market power and an analysis of competition for the purpose of criterion (a). They note Professor Brunt’s statement that market definition is ‘an instrumental concept designed to assist in the analysis of processes and sources of market power.’ (Frontier Economics 2003a, p. 19)

### 6.77
While the Council recognises the established jurisprudence that market definition is a tool for the purpose of analysing the issue at hand, it also recognises that the test of substitutability (both demand
and supply side) remains the key definer of markets (see paragraphs 6.8 to 6.13). The Council considers that it is not appropriate to alter a market definition arrived at by application of the substitutability test, so that the definition can be more easily linked to the specific activities of the monopoly service provider. Such an approach runs the risk that the relevant dependent market may be defined too narrowly. Thus overstating the competitive detriment that may arise from an exercise of market power in the dependent market by the monopoly service provider.

6.78 Nevertheless, the ‘practical approach’ Virgin Blue and Frontier Economics advocate is useful in approaching the competition analysis required under criterion (a). The Council recognises the significance of routes into and out of Sydney Airport (see paragraphs 6.109 to 6.113 for further discussion) and considers it appropriate to consider the competition effect of declaration on these routes in determining the impact of declaration on the whole domestic passenger market. It does not necessarily follow, however, that the bundle of routes delineates a separate market.

6.79 The Council is satisfied on the basis of the evidence set out above that there is significant supply side substitutability between domestic routes such that the geographic dimension of the relevant dependent market is the domestic market as a whole.

6.80 A further issue as to the geographic dimension of the passenger air services market relates to the division between domestic (interstate) and regional (intrastate) services. In its submission, SACL argued that domestic and regional services constitute different markets. In support of this view, SACL stated that there is a lack of supply side substitutability between the services due to the regional ring fencing arrangements under the Sydney Airport slot management arrangements. Under these arrangements, a slot used for regional services cannot be used for non-regional services although non-regional slots can be used for regional services. In addition, regional services at Sydney Airport continue to be subject to the prices notification regime under section 22 of the Prices Surveillance Act 1983 (Minister’s Declaration 90). This means that SACL is prohibited from increasing prices for airside services for regional services if the ACCC objects to such a price increase. The Government explicitly requires the ACCC to object to unjustified price increases greater than the CPI for regional airlines.

6.81 The Council recognises that the regulatory protections afforded regional services into and out of Sydney Airport limit supply side
substitutability possibilities between non-regional services and regional services. Consequently, SACL’s ability to exercise market power in respect of regional services is limited. The Council is not satisfied that criterion (a) is met in respect of the domestic passenger market (see paragraphs 6.272 to 6.273). The Council, therefore, has considered whether declaration will promote competition in the narrower market of routes into and out of Sydney Airport. The Council’s conclusion has not been altered by examining the impact in the narrower market, including regional markets.

Functional market dimension

6.82 In determining whether the service that is the subject of a declaration application is in the same or different market from the market(s) in which competition is said to be promoted, the Council considers whether the markets are functionally distinct. Markets are functionally distinct if they comprise fields of competition at different vertical stages of production and/or distribution. Markets are functionally separate if:

(a) the layers at issue are separable from an economic point of view (economically separable). That is, the transaction costs in the separate provision of the good or service at the two layers cannot be so large as to prevent such separate provision from being feasible.

(b) each layer uses assets sufficiently specific and distinct to that layer such that the assets cannot readily produce the output of the other layer (economically distinct).

6.83 The Council considers it clear that SACL’s Airside Service falls within a functionally distinct market to the Domestic Passenger Market and freight markets. The Airside Service is an input into the provision of domestic air passenger services. The provision of the Airside Service and the provision of domestic passenger services are economically separable. This is evidenced by the fact that the services are provided by distinct entities, that is, the Airside Service is provided by SACL whereas air passenger services are provided by airlines. The services are also economically distinct in that they are provided using distinct and non-interchangeable infrastructure. The Airside Service is provided using Sydney Airport whereas aircraft are needed in order to provide an air passenger service. The same distinction applies to freight services.
Temporal market dimension

6.84 The temporal dimension of the market refers to the period over which substitution possibilities need to be considered. The Council generally has regard to long run rather than short run time periods in defining markets. This recognises that with a longer time dimension consumers (including airlines) have a greater ability to substitute other sources of supply in response to a price rise.

6.85 For this reason, in determining the boundaries of the relevant dependent market, the Council’s analysis of substitution possibilities focuses not only on the short term but also on the medium to long term (see paragraphs 6.72, 6.36 and 6.72 for examples).

Relevant freight markets

6.86 Freight services are in a separate product market from passenger services (see paragraph 6.62). For the purpose of criterion (a), the Council needs to consider the dependent freight product market.

6.87 Air, road, rail and sea are viable alternatives used for the transport of freight. Demand for these freight services is largely determined by the characteristics of the freight to be handled. The most significant characteristics are the size of the consignment; the value of the freight relative to its volume and weight; the time-sensitivity of the freight; and the particular points of origin and destination for the freight. Other factors can also be significant, such as the freight’s susceptibility to damage and the need for efficient logistics such as the need to minimise double-handling.

6.88 At its broadest, the Council considers that the relevant dependent freight market could be general domestic freight. This market would include all modes of transport and not differentiate between types of freight or transport demand characteristics such as time sensitivity.

6.89 At its narrowest, the Council considers the relevant freight market could be limited to air transport. Air freight typically consists of low volume and/or high value products that have time-sensitive delivery requirements. Examples include express parcels, medical supplies, live seafood and high technology parts. Depending on the distance to be travelled and the time sensitivity of the freight there is often an absence of effective inter-modal competition. In its submission to the PC inquiry into the price regulation of airport services, Virgin Blue
suggested there is a separate market for time sensitive freight. Virgin Blue stated that:

_The means of freight transport is determined by the required delivery time and characteristics of the freight item. Air transport is higher cost than other forms of transport, reflecting its short delivery time. Highly time sensitive freight is typically only suitable for air transport._ (Virgin Blue 2001, p. 12)

6.90 On the issue of whether a separate air freight market existed, the Council notes the views of NECG (on behalf of Qantas) which were put to the ACCC in the authorisation matter of the Qantas/Air New Zealand alliance:

_Our view is that there is a continuum where, at one extreme, there is freight that is highly non-time critical. Delivery by a range of transport modes, including delivery by sea, may be viable. At the other extreme, there is freight that is time critical. In these instances, only certain types of transport may be viable as modes of delivery, including delivery by air or, where feasible, rail delivery or “door to door delivery” by road. Consistent with this, our view is that air freight services are likely to be included in a market for time critical freight._ (NECG 2002, pp. 62–3)

6.91 A further issue is the geographic dimension of an air freight market. On the demand side, it may be the case that on certain long distance routes, the geographic dimension of the market is limited to the point of origin and point of destination. Alternatively, appropriately located regional centres may make it possible to commence or complete the freight’s transport using modes other than air. This possibility also depends on the time-sensitivity of the freight concerned.

6.92 On the supply side, the Council notes that unlike the market for passenger services, there is little scope for substitutability between different routes. Apart from dedicated freight operators which only make up a small proportion of the total air freight market (see paragraph 6.45), airlines make operational decisions in relation to the scheduling and deployment of aircraft almost solely on the basis of the passenger market and with little regard to the freight market (see paragraph 6.61). As such, changes in demand conditions for freight on a particular route will, in the absence of changes in the passenger market, have little (if any) impact on an airline’s air freight operations. In other words, an increase in demand for freight on a particular route is unlikely to have an impact (either in terms of price or capacity) on other air freight routes. This suggests that there
is little scope for air freight supply side substitutability between different routes and that each route may fall into a separate market.

6.93 At it narrowest, the relevant freight market could be distinct air freight markets based on particular city pairs or regional centres.

Other markets

6.94 In its submission, BARA argued that Virgin Blue’s application ‘and consequent declaration, should not be confined to services for aircraft carrying domestic passengers, but also international passengers.’ (BARA 2003a, p. 3)

6.95 Virgin Blue also stated in its submission that:

*there is no reason why the Airside Service should be limited to the use of facilities by aircraft carrying domestic passengers... Therefore, Virgin Blue considers that the Council should consider recommending the declaration of a service which is not limited to aircraft carrying domestic passengers.* (Virgin Blue 2003a, p. 4)

6.96 The Council advised both BARA and Virgin Blue that as the Airside Service was confined to ‘aircraft carrying domestic passengers’, it would significantly change the nature of the definition to broaden it to include international aircraft. Accordingly, the Council considered that it was unable to consider an amended service definition in the absence of a formal request to amend the original application. No such request was made.

6.97 The issue for the Council is whether access to the Airside Service (defined in terms of the provision of services to domestic aircraft) would promote competition in a market in which international air services are provided. The Council considers that the impact on airline services that flow into international services, that is, international feeder services, would be substantially the same as the impact on routes into and out of Sydney. The Council notes Virgin Blue’s view that many of the arguments it raised in relation to the definition of the relevant dependent markets and criterion (a) ‘apply equally to the market in which aircraft carrying international passengers to and from Sydney operate’ (Virgin Blue 2003a, p. 9). The Council considers, however, that if competition would not be promoted in a domestic market through declaration of the Airside Service, then it would not be promoted in a larger international market.
Conclusions on relevant dependent markets

6.98 The Council considers that the principal dependent market for the purpose of assessing Virgin Blue’s application against criterion (a) is the market for domestic passenger air transport services (Domestic Passenger Market). The Council also considers that other relevant markets could include the routes into and out of Sydney for regional air passenger transport and city pair or regional centre air freight markets (which are the narrowest possible markets relevant to freight transport services to and from Sydney).

Will access (or increased access) promote competition in a dependent market?

General approach

6.99 The Council must consider whether access (or increased access) facilitated by declaration of the Airside Service would promote a more competitive environment in the Domestic Passenger Market and in the other possible dependent markets identified in paragraph 6.98. In doing so, the Council compares the future competitive environment in the dependent markets if the Airside Service was declared against that if the service was not declared.

6.100 Of critical importance in the assessment of this counterfactual, is whether SACL has market power that could be used to adversely affect competition in the dependent market(s). In the Duke EGP decision, the Tribunal stated:

Whether competition will be promoted by coverage is critically dependent on whether EGP has power in the market for gas transmission which could be used to adversely affect competition in the upstream or downstream markets. There is no simple formula or mechanism for determining whether a market participant will have sufficient power to hinder competition. What is required is consideration of industry and market structure followed by a judgment on their effects on the promotion of competition. (Duke EGP decision para 116)
Domestic Passenger Market

Ability and incentive to exercise market power

General approach

6.101 In paragraph 5.37, the Council concluded that Sydney Airport as a whole was a natural monopoly. Accordingly, SACL has natural monopoly power in respect of the provision of the Airside Service.

6.102 The issue for the purpose of criterion (a) is whether SACL has the ability and incentive to exercise its market power to adversely affect competition in the Domestic Passenger Market. In other words, the Council needs to consider what (if any) are the constraints on SACL from exercising market power to harm competition in the dependent market.

6.103 It is important to note that while evidence of current or past conduct (such as monopoly pricing) may indicate an exercise of market power by the service provider to adversely affect competition in a dependent market, the absence of such evidence does not mean that the requisite market power is absent. Rather, the Council needs to consider whether there are constraints on the service provider’s ability and incentive to exercise market power such that the service provider cannot or will not exercise market power to the detriment of competition in the dependent market.

6.104 As discussed in paragraph 6.2, only if SACL has both the ability and incentive to exercise market power in one of the following three ways would declaration of the Airside Service be likely to improve the competitive conditions in the Domestic Passenger Market; that is, by:

(a) imposing access terms and conditions that result in the extraction of monopoly returns, such as by charging monopoly prices for the provision of the Airside Service;

(b) engaging in explicit or implicit price collusion; and/or

(c) engaging in strategic behaviour designed to leverage its monopoly power into the dependent market to the advantage of a vertically related affiliate or some other entity.
6.105 The Council is not aware of any possibilities of SACL exercising market power by engaging in price collusion. This is due to the absence of rival competition for the Airside Service (see the Council's analysis of criterion (b) starting at paragraph 5.17). In addition, SACL noted that 'airport services are not vertically integrated (SACL 2003a, p. 4). The Council has taken this to mean that SACL is not vertically integrated in a way that would enable it to engage in strategic behaviour to advantage a vertically related affiliate. The Council is also unaware of any other arrangement SACL may have with a functionally distinct entity, such as an airline, that would cause SACL to leverage its market power to advantage that entity and itself. Accordingly, the Council will focus its enquiry on market power to a consideration of whether SACL has the ability and incentive to impose terms and conditions of access that result in the extraction of monopoly returns, such as by charging monopoly prices for the provision of the Airside Service.

6.106 While Virgin Blue accepted that the existence of market power was a necessary condition for the satisfaction of criterion (a), it did not accept that there was a separate requirement that the service provider have an incentive to use its market power. In particular, Virgin Blue expressed concern that the Council appeared to be introducing a purposive element into criterion (a) by requiring that the service provider have an incentive to use its market power for the purpose of adversely affecting competition in the relevant market (Virgin Blue 2003a, pp. 10-11).

6.107 The Council reiterates its position that in addition to an ability to exercise market power, it must be satisfied that the service provider has the incentive to use its market power to adversely affect competition in a dependent market. In the absence of such an incentive, access facilitated by declaration would have no effect on the competitive environment in the dependent market. Accordingly, it would not promote competition in the dependent market and criterion (a) would not be satisfied.

6.108 The Council does not consider whether the service provider intended to harm competition through the exercise of market power. Rather, the focus is on whether a service provider has the incentive to exercise its market power such that its use will have the effect of adversely affecting competition in a dependent market. The Council considers this approach to be consistent with that adopted by the Tribunal:

*The Tribunal does not consider that the notion of “promoting” competition …requires it to be satisfied that there would be an*
advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of “promoting” competition ...involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given [declaration], will be better than they would be without [declaration]. (Sydney Airport Decision para 106)

6.109 A further issue relates to the relationship between routes into and out of Sydney Airport and the Domestic Passenger Market as a whole. An exercise of market power by SACL will have its most direct effect on services into and out of Sydney Airport. For the reasons set out in paragraph 6.78, the Council considers that such services do not constitute a distinct market but form part of the broader Domestic Passenger Market.

6.110 Sydney Airport is a significant domestic airport and of crucial importance to national domestic carriers. In particular, the Council notes that Sydney Airport is Australia’s largest and busiest airport in terms of passenger numbers. It accounts for 30 per cent of Australia’s domestic passenger traffic, 50 per cent of its international passenger traffic and 44 per cent of its air freight (SACL 2003c, p. 5; SACL 2003e, p. 43).

6.111 Virgin Blue noted the importance of Sydney Airport for national carriers given the numbers of domestic passengers passing through Sydney Airport and also its importance as a domestic hub and in providing international feeder traffic. Virgin Blue noted that for national carriers intent on operating national networks:

it is critically important for that airline to operate into and out of Sydney Airport due to the volume of Australian domestic passenger traffic that routes into and out of Sydney represent (in excess of 50%) and the significant efficiency benefits that come through being able to offer interconnecting flights into and out of Sydney. (Virgin Blue 2003c, p. 6)

6.112 In concluding that Sydney Airport possessed substantial market power, the PC noted that Sydney Airport had a high proportion of more price inelastic travellers (that is, those travelling on business or those visiting friends and relatives), did not face significant competition for domestic passengers from other airports and was of importance as an international passenger point of arrival and departure (PC 2002, pp. 134-135).
6.113 Given the importance of Sydney Airport to the Domestic Passenger Market, the Council considers that any adverse effect on competition on routes into and out of Sydney flowing from the exercise of market power by SACL is likely to adversely affect competition in the Domestic Passenger Market as a whole.

6.114 The promotion of competition requirement in criterion (a) refers to an improvement in the opportunities and environment for competition such that competitive outcomes are more likely to occur. It is not concerned with protecting or enhancing the competitive position of particular competitors. In the Sydney Airport decision, the Tribunal stated that:

The Minister and the Tribunal do not look at the promotion of ‘competitors’ but rather the promotion of ‘competition’. Such an analysis is not made by reference to any particular applicant seeking to have a service declared. (para 21)

6.115 The Tribunal further stated that it:

is concerned with furthering competition in a forward looking way, not furthering a particular type or number of competitors. (para 108)

6.116 Accordingly, evidence that the exercise of market power by SACL may harm Virgin Blue commercially is not enough to conclude that the conduct has adversely affected competition for the purpose of criterion (a). However, if the exercise of market power is likely to harm competition in relation to a particular segment of the market, such as the more price elastic customer segment of the Domestic Passenger Market, the requisite effect on competition may be established. This segment tends to be targeted by low cost carriers such as Virgin Blue. The Council, however, recognises that as the current Domestic Passenger Market is made up of only two national carriers, namely, Qantas and Virgin Blue, it may be difficult to differentiate the effect of conduct on the market generally and on individual competitors specifically.

Ability to exercise market power

6.117 As noted above at paragraphs 6.109 to 6.113, Sydney Airport is of critical importance to national network carriers. This is because of the large proportion of domestic traffic passing through Sydney Airport and its importance as a hub for interconnecting domestic and international services. Given this importance, it could be argued that any increase in charges for the Airside Service would have little
impact on whether passengers and airlines choose to use Sydney Airport. Accordingly, this would enhanced SACL’s ability to exercise market power.

6.118 SACL’s market power could, however, be constrained by the countervailing market power of airlines or competition from other airports, including the prospect of a second Sydney airport.

Countervailing power of airlines

6.119 A number of submissions received by the Council argued that SACL’s ability to exercise market power is limited by the countervailing power of the airlines.

6.120 Countervailing power refers to the strength of the bargaining power of airlines in relation to airports, and the ability of airlines to bypass or withdraw services from a particular airport. King stated that to determine if countervailing power is relevant:

consideration must be given to the bargaining position of buyers and sellers. In particular, it is important to consider which parties will lose the most from any failure to reach an agreement to trade the relevant product. For countervailing power to exist in a market that otherwise is deficient in competition, any loses [sic.] from a break-down in bargaining need to be predominantly bourn [sic] by the seller. (King 2001, p. 13)

6.121 SACL argued that despite the relative size of Sydney Airport, it believes that airlines have demonstrated the strength of their countervailing power on a number of occasions. SACL argued that:

The fact that airports require sustained levels of traffic and passenger throughput in order to maintain not only their aeronautical revenue streams but also their non-aeronautical revenues clearly gives airlines a significant degree of countervailing power. The airport/airline relationship is not one of monopoly vendor and powerless purchaser. The close interdependence between the two, particularly in the case of major interstate carriers, means that the relationship is far more closely balanced and that the scope for misuse of market power by an airport is greatly dissipated, if not negated. (SACL 2003a, p. 8)

6.122 DOTARS commented that:

SACL illustrates the use of countervailing power by Virgin Blue in negotiations concerning this case, where the airline ‘not only initiated legal action but …undertook a robust and targeted publicity campaign against the airport and its major shareholders …and lodged an application for access under Part IIIA’. (DOTARS 2003b, p. 6)
Perth Airport also raised the countervailing power argument noting that:

*the Productivity Commission found, that despite the major metropolitan airports such as Sydney, Melbourne and Brisbane having substantial market power, there was little prospect of airports using this power in a way that would produce large costs for the community or the economy. It argued that any attempts by airports to exercise their market power might be prevented by countervailing action by airlines, and that the reduction in demand for airport services since September 2001 is likely to have enhanced airline countervailing power, at least in the short term.*

(WAC 2003, p. 8)

In contrast, Virgin Blue argued that:

*An airline cannot offer a truly national domestic network unless it flies to the capital cities of all States. In any negotiations with SACL, Virgin Blue cannot credibly signal to SACL that it would refuse to offer flights into and out of Sydney given its clearly stated business objectives.*

(Virgin Blue 2003a, p. 19)

The PC considered the issue of countervailing power in its inquiry in some detail. It noted the importance of larger core-regulated airports such as Sydney, Melbourne, Brisbane and Perth to airline networks and national network carriers. Overall the PC concluded that:

*evidence suggests that scope for competition in the aviation market and the importance of major airports to airline networks will limit (though not necessarily rule out) airline countervailing power in their dealings with the major capital city airports.*

(PC 2002, p. xxviii)

In response to the Council’s draft recommendation, the PC added that ‘competition in aviation markets would tend to reduce scope for airline countervailing power in negotiations with airports, and generate increased traffic, both of which would benefit airports’ (PC 2003b, p. 3).

The Council considers that the degree of countervailing power of national airlines is not sufficient to constrain SACL’s ability to exercise market power to adversely affect competition. This is because of Sydney Airport’s importance to the national carrier network (see paragraphs 6.109 to 6.113) and the inability of airlines to credibly threaten to bypass or withdraw from Sydney Airport. The Council would expect the degree of countervailing power that smaller non-national carriers could exercise in respect of Sydney Airport would be even more limited.
Bankstown Airport and a Second Sydney Airport

6.128 It is necessary to consider whether Bankstown Airport and the prospect of a second Sydney Airport constrain SACL’s ability to exercise market power.

6.129 In relation to a second Sydney Airport, the Council notes that the sale of Sydney Airport to Southern Cross Consortium included a right to build a second Sydney Airport. This reflects the requirement in s. 18 of the Airports Act 1996 that the leases for Sydney Airport and the second Sydney airport must only be granted or transferred by the Minister to lessees that are subsidiaries of the same company. Given this requirement, the Council does not consider that a second Sydney airport owned and operated by a company related to SACL would constrain SACL’s ability to exercise market power in relation to Sydney Airport.

6.130 In its environmental assessment report on the second Sydney airport proposal, DOTARS dismissed Bankstown Airport as an alternative to Sydney Airport. DOTARS stated:

Bankstown is not capable of handling major jet services, but could handle small volumes of regional traffic without adversely affecting the operation of Sydney Airport …Better facilities and improved road access would be required before passengers using regional services would be attracted to Bankstown Airport. However, it is likely that regional passengers would prefer to use Sydney Airport, where they currently have guaranteed access through the slot scheme. Changes to the operation of Bankstown Airport could improve the capacity of Sydney Airport in the short-term, but would not assist in satisfying long-term air travel demand. (DOTARS 1999)

6.131 DOTARS’ views accord with those of Virgin Blue, which argued that Bankstown Airport, was unable to service large aircraft or provide interconnecting services that are available at Sydney Airport (see paragraph 5.16). The Council accepts these views and considers that Bankstown Airport does not constrain SACL’s ability to exercise market power.

Conclusion on ability

6.132 Airlines competing on routes into and out of Sydney Airport require the Airside Service. There is at present no feasible opportunity for airlines on these routes to bypass the need to acquire the Airside Service at Sydney Airport from SACL. Accordingly, SACL’s market
power is not constrained through the existence of alternative sources from which competitors could acquire necessary inputs. This conclusion also applies in relation to the Domestic Passenger Market given the importance of Sydney Airport to that market (see paragraphs 6.109 to 6.113.

6.133 Although SACL may currently charge for the Airside Service at a competitive level or even below, there is no evidence to suggest that SACL's ability to increase prices above this level is constrained. Whether it has the incentive to do so is considered below, followed by a consideration of whether a price increase could deter entry or expansion on routes into and out of Sydney to adversely affect competition in the Domestic Passenger Market.

6.134 While the ability to monopoly price is arguably the clearest example of an exercise of monopoly power, market power can be exercised through the imposition of other terms and conditions of access. The Council considers there to be nothing constraining SACL from exercising its monopoly power by imposing other terms and conditions of access that result in it extracting monopoly returns. While SACL is not responsible for the allocation of slots at Sydney Airport, there may be other important terms and conditions of access that SACL may impose in the exercise of its monopoly power that may adversely affect competition. For example, there is nothing constraining SACL’s ability to change its charging structure unilaterally in a manner that may adversely affect competition in the dependent market (whether SACL has the incentive to do so is considered immediately below).

Incentive to exercise market power

6.135 While concluding that SACL has the requisite ability to exercise its natural monopoly power to adversely affect competition in the Domestic Passenger Market, the Council needs to consider whether SACL has the incentive to do so. In particular, the Council considered substantial evidence suggesting that there was an absence of the requisite incentive as SACL:

- has an interest in increasing passenger numbers using Sydney Airport due to the importance of non-aeronautical revenue such as rental revenue from airport commercial tenants; and

- is subject to the threat of re-regulation by the Government in the event that it was to exercise market power.
Effect of non-aeronautical revenue

6.136 SACL noted that in 2001-02, its aeronautical revenues were $180 million, compared with $246 million from non-aeronautical activities (SACL 2003a). Virgin Blue referred the Council to the ACCC’s Regulatory Report into Sydney Airport for 2001-02 which stated that Sydney Airport’s aeronautical revenue for the financial year ended 30 June 2002 was $228 million and its non-aeronautical revenue was $223 million (Virgin Blue 2003d). SACL advised the Council that the difference in figures is a result of the ACCC including a number of related charges as aeronautical revenue, such as the recovery of mandated security costs, property rentals, check-in counter rental and parking fine revenues.

6.137 Given the importance of non-aeronautical revenue, SACL argued that ‘airports do not have any incentive whatsoever to restrict access to airport facilities or to constrain throughput’. It went on to argue that:

Changing terms and conditions to disadvantage Virgin Blue would in all likelihood reduce SACL’s total aeronautical earnings, and would not optimise associated non-aeronautical charges. SACL’s strongest incentive is to promote healthy competition in the markets for flights to and from Sydney and, in doing so, optimise aeronautical and non-aeronautical revenues. (SACL 2003a, p. 4)

6.138 SACL also noted that it actively facilitated Virgin Blue’s entry into Sydney Airport by, for example, constructing a common-user terminal specifically for Virgin Blue and the other new entrant at the time, Impulse. This terminal, known as the Domestic Express Terminal, accommodated Virgin Blue’s operations until it recently moved its operations to the former Ansett terminal which was acquired by SACL for use as a common user terminal (Terminal 2).

6.139 Melbourne Airport noted SACL’s support of Virgin Blue’s entry into the market stating that:

We would suggest that the efforts made by major Australian airports, and in particular Melbourne and Sydney Airports, to facilitate the entry of Impulse and Virgin Blue indicates that airport incentives are such that airports act to encourage airline entry, not discourage it. (Melbourne Airport 2003, p. 5)

6.140 SACL referred the Council to provisions in Sydney Airport’s conditions of use that set out instances in which SACL would consider discounts for new entrants. The provisions note that ‘SACL
Revenues from duty-free shopping and other retailing activities, car parking and property developments are a large and increasing part of airport revenues. The PC referred to a table submitted by the ACCC, which compared average earnings per passenger movement (profit before abnormals, interest, tax, depreciation and amortisation (EBITDA)) flowing from non-aeronautical activities and aeronautical activities in 1999-2000. It showed that Sydney Airport earned $1.76 EBITDA per passenger from aeronautical activities compared to $6.36 EBITDA per passenger from non-aeronautical activities (PC 2002, p. 182).

On this basis, the PC concluded that:

*Profits from non-aeronautical activities at most core-regulated airports appear significant, especially when compared with current earnings from regulated aeronautical charges. Though this earnings disparity may be expected to be somewhat less if price regulation of aeronautical services were removed, there is an incentive for airports to temper prices for aeronautical services (particularly for additional services and new entrants), improve quality and/or increase aeronautical capacity to encourage passenger growth and non-aeronautical revenue. The magnitude of non-aeronautical earnings suggests that the effects on aeronautical prices would be significant.* (PC 2002, p. 188)

Virgin Blue referred to the ACCC submission to the PC inquiry. The ACCC commissioned NECG to comment on the issue. NECG concluded that:

*[E]ven if an airport were motivated, for the sake of maximising profits from aeronautical and non-aeronautical services combined, to set aeronautical prices below the stand-alone profit maximising level, the new level is still likely to be well above the cost-reflective aeronautical price level which would result from either a workably competitive airport market or from cost of service regulation of airports. Consequently, the contention that a desire to maximise the combined profitability on aeronautical and non-aeronautical services would neutralise the allocative inefficiency arising from unregulated aeronautical prices, is not well supported by the evidence contained in the Draft Report.* (Virgin Blue 2003a, p. 14)

Frontier Economics argued similarly in its submission to the Council. It noted that the PC was ‘careful to distinguish between the relationship between the prices of different services that are offered by SACL and the level of those prices.’ The fact that SACL would be expected to take into account complementarities between
aeronautical and non-aeronautical revenues in setting prices ‘in no way affects the notion that a profit-maximising monopoly will charge prices substantially above the competitive level’ (Frontier Economics 2003a, p. 11).

6.145 In essence, Frontier Economics argued that the profit maximising price for a monopolist that produced only one product would be at a higher price than the profit maximising price set by a monopolist that took into account complementarities in production. This latter price would, nonetheless, be substantially higher than the efficient competitive price for the product (Frontier Economics 2003a).

6.146 Economic theory recognises that a multiproduct firm will maximise its profit across all its products, not on each product separately. The multiproduct producer consequently takes into account the interrelationship between the demand for these products when it sets its prices. If these products are complements then the producer will recognise that increasing the sale of one product will increase the sales of complementary products. This additional benefit will encourage the producer to sell more than would otherwise be the case (Economides and Salop 1992).

6.147 In relation to the application of the theory to the operation of airports, the Council was referred to a recent study, which concluded that price regulation might still be warranted for profit maximising airports. This view was based on a conclusion that while an airport service provider would take into account non-aeronautical services revenue when setting the price of aeronautical services, this alone would not be sufficient to provide the service provider with the incentive to price aeronautical services at competitive levels (Oum et al 2003).

6.148 In the case of Sydney Airport, SACL would be expected to price the Airside Service taking into account the effect that such a price would have on passenger throughput, and in turn, on non-aeronautical revenue. SACL’s profit maximising position would be to increase the price of its Airside Service charges until the additional revenue resulting from the charge increase was outweighed by the decrease in revenue that would flow from fewer passengers using the airport and lost non-aeronautical revenue. This does not, however, mean that SACL’s behaviour, while profit maximising, is necessarily anti-competitive.
6.149 Criterion (a) will only be met if the degree to which access promotes competition in the Domestic Passenger Market is material, that is, not insignificant.\footnote{All future references to ‘material’ should be interpreted as meaning ‘not insignificant’.} In relation to pricing conduct, the Council needs to be satisfied that SACL has the ability and incentive to price at such a level above competitive levels that the adverse effect on competition would be material. Relevant to this enquiry is the question of what would be SACL’s profit maximising price level for the Airside Service taking into account the constraining effect of non-aeronautical revenues.

6.150 Virgin Blue argued that ‘a careful reading of the Airport Regulation Report reveals that the Productivity Commission did not conclude that airports with significant market power would not raise prices for aeronautical services above competitive levels.’ Virgin Blue went on to refer to the PC’s statement that:

\textit{How far beyond their efficient levels or, indeed, whether aeronautical prices at airports with market power would increase in the absence of any airport-specific price regulation, no-one can say with any certainty.} (Virgin Blue 2003a, p. 13)

6.151 Virgin Blue also made the point that:

\textit{If we were to assume prices for aeronautical services have in the past been constrained by regulation to levels that approximate competitive levels, and prices for non-aeronautical services are constrained to some extent by competition, then when regulatory constraints on prices for aeronautical services are removed, the profit maximising monopolist would be expected to increase its prices for aeronautical services to monopoly levels.} (Virgin Blue 2003d, p. 11)

6.152 Frontier Economics provided the Council with economic modelling, which considered in quantitative terms the degree to which non-aeronautical revenues would constrain SACL’s pricing behaviour in respect of the Airside Service. The submission considered three scenarios taking into account varying price elasticities of demand for air travel with respect to a change in the price of air travel and with respect to a change in the price of the Airside Service, and varying proportions of SACL’s total aeronautical revenue made up of the Airside Service revenue (Frontier Economics 2003b).
6.153 Frontier Economics’ analysis suggested that on the base case scenario 1\(^{21}\), SACL would be able to increase its total revenue by increasing the price of the Airside Service by as much as 1000 per cent notwithstanding that this price increase would result in an expected 30 per cent drop in passenger throughput (Frontier Economics 2003b, p. 14). On the basis of the scenario 3\(^{22}\), SACL would still be able to increase its total revenue by increasing the price of the Airside Service by as much as 800 per cent notwithstanding an expected drop in passenger throughput of 28 per cent (Frontier Economics 2003b, p. 15). In other words, even if SACL were to increase the price of its Airside Service by such a degree, the effect on SACL’s total revenue would still be positive. This leads to the conclusion that on its own, non-aeronautical revenue is not a significant constraint on SACL’s pricing behaviour in respect of the Airside Service.

6.154 The Council notes, however, that Frontier Economics did not take account of the possible indirect effects of an increase in airside charges, such as a fall in lease values that may result from the fall in demand. Such impacts may reduce SACL’s ability to raise airside charges to those levels modelled by Frontier Economics.

6.155 In its response to the Council’s draft recommendation, the PC stated that its ‘analysis indicated that non-aeronautical revenues were likely to be a significant constraint on airport pricing behaviour’ (PC 2003, p. 4). The Commission noted that somewhat similar scenarios to those provided to the Council by Frontier Economics were received during its inquiry from Network Economics Consulting Group (as consultant to ACCC) and Frontier Economics (as consultant to the BARA). In its assessment of the models the Commission found that:

\[T\]he scenarios generally assume low demand elasticities for air travel, while airlines typically argue that price responsiveness of air travellers is quite high. The Commission noted that the elasticities used in calculations presented appeared too low, allowing for little if any scope for competition from other airports and destinations or travel modes. (PC 2003, p. 4)

\(^{21}\) The base case scenario 1 assumes a price elasticity of demand for air travel with respect to a change in the price of air travel of -1; a price elasticity of demand for air travel with respect to a change in the price of the Airside Service of -0.03; and revenue from that the Airside Service accounts for approximately 25 per cent of SACL’s total aeronautical revenue (Frontier Economics 2003b, p. 12).

\(^{22}\) Scenario 3 assumed a price elasticity of demand for air travel with respect to a change in the price of air travel of -1.5; a price elasticity of demand for air travel with respect to a change in the price of the Airside Service of -0.05; and revenue from that the Airside Service accounts for approximately 20 per cent of SACL’s total aeronautical revenue (Frontier Economics 2003b, p. 12).
6.156 All of the evidence before the Council supports the conclusion that non-aeronautical revenues do temper SACL’s incentive to charge monopoly prices for the Airside Service but that this tempering effect would not drive down prices to competitive levels. The main point of difference between the submissions received is the degree to which non-aeronautical revenues constrains SACL’s exercise of market power. The Council considers that the degree to which SACL’s ability and incentive to raise price of the Airside Service above competitive levels is not significantly constrained by non-aeronautical revenues.

6.157 In coming to the above conclusion, the Council notes SACL’s concerns that the Council has considered this issue in isolation. The Council clarifies, however, that its conclusion takes into consideration all available information and does not rely on an assessment of this issue alone. (The additional constraint of the threat of re-regulation is considered from paragraph 6.159).

6.158 The Council’s analysis in relation to SACL’s expected pricing behaviour taking into account non-aeronautical revenues applies equally to SACL’s incentive to exercise its market power to impose other terms and conditions of access so as to extract monopoly returns and adversely affect competition.

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6.159 SACL argued that the threat of re-regulation by the Government ‘provides a strong disincentive for airports to use market power in a way that affects competition between airlines’ (SACL 2003b, p. 5).

6.160 In response to the Council’s draft recommendation, SACL added:

SACL’s shareholders, and indeed those of other major Australian airports, recognise that the airport lease is a valuable and very long-lived asset. Rational behaviour would not be to attempt to extract additional aeronautical revenue in the short term at the possible expense of long-term pricing and regulatory flexibility ...

SACL interacts with government in relation to a wide range of aspects of airport business, including airport planning and development and non-aeronautical revenue controls and arrangements. While governments must make all such decisions on their merits, it is in Sydney Airport’s best interests to ensure that it is viewed by governments and the community as an organisation that does not inappropriately exercise its market position across any of the areas of its operations. (SACL 2003f, p. 8)
6.161 The PC, in its inquiry into price regulation of airport services argued that the threat of re-regulation together with prices monitoring by the ACCC under the Prices Surveillance Act 1983 (PSA) and the continuing application of the declaration provisions of Part IIIA would constrain the exercise of market power by airport operators. The PC concluded that:

*By providing a credible threat that price controls could be reintroduced, enunciating principles of efficient pricing to guide airport behaviour, and imposing disclosure requirements, any tendency for airports to increase their charges beyond efficient levels should be constrained …* [The potential activation of] *[the declaration] mechanism does provide users with regulation of last resort, providing additional encouragement for airports to enter into reasonable agreements regarding prices and conditions of airport use.* (PC 2002, p. 356)

6.162 The PC also noted that:

*The Commission emphasises that it is not advocating deregulation of major airports. It is proposing a probationary regulatory package designed to facilitate the transition to a more commercial environment, while providing credible constraints on the use of market power by these airports.* (PC 2002, p. 357)

6.163 The PC noted that a credible threat of re-regulation was a necessary part of making prices monitoring work. It stated that:

*to ensure that market power is not abused, lower levels of regulatory intervention in price setting must be balanced by a credible threat that abuse of market power can and will be identified and appropriate action taken.* (PC 2002, p. 323)

6.164 The PC went on to quote from the submission of Professor Forsyth (Monash University) as follows:

*The threat to regulate is not the same as actual regulation, but its impacts on the firm may well be much the same. The regulated firm does not know what behaviour on its part will induce the regulator to impose formal regulation. One possible trigger might be its profitability; if the firm earns high or supernormal profits, the regulator may intervene.* (Forsyth 2001, p. 19)

6.165 The PC concluded that the best method of achieving this objective was by an explicit recognition that a review of regulatory arrangements will take place at a defined time in the future (for example, after five years). The PC stated:

*If it were made clear, however, that any such regulation would not be reintroduced within a predetermined period, there would be less
potential for the undermining of bona fide commercial negotiations. A review at the end of that period could then assess whether stricter forms of price regulation, further monitoring, or any other action were warranted at individual airports. The monitoring period would need to be long enough to encourage commercial negotiation, but not so long that the threat of reintroduction of stricter forms of price regulation was not an effective deterrent against abuse of market power. The review at the conclusion of the monitoring period could take into account changes in the competitive environment in which an airport operates and the behaviour of the various parties during the monitoring period. Information collected through monitoring could form part of that assessment. (PC 2002, p. 324)

6.166 In summary, the regulatory framework proposed by the PC as a means of constraining the exercise of market power by major airports involved the credible threat of re-regulation through prices monitoring over a set review period.

6.167 The Commonwealth Government accepted the PC’s regulatory framework recommendation for major airports including Sydney Airport. In particular, the Government implemented price monitoring arrangements to replace price caps and prices notification for some airports. The Government accepted a probationary period of five years toward the end of which there would be an independent review to assess the need for the reintroduction of greater price regulation. The Government stated that:

The Government supports the Commission’s recommendation that there be an independent review towards the end of the five year regulatory period to assess the need for continued price regulation. Sufficient time needs to be given for the airports and stakeholders to bed down a commercially negotiated operating environment. In that regard there is an expectation that airport operators will implement transitional arrangements that are mindful of the impacts on the industry from adopting efficient pricing principles, and will negotiate with stakeholders a path by which they may be achieved over time. (Anderson and Costello 2002)

6.168 Under the current prices monitoring arrangements, SACL is required to notify the ACCC of an intention to increase aeronautical charges. The ACCC is directed by the Minister to monitor prices, costs and profits (s. 27A) and report to the Minister and the public on that monitoring (s. 27B). If monitoring indicates that further investigation is required, the Minister can direct the ACCC to undertake a public inquiry or approve the ACCC holding an inquiry (s. 18). Powers for the ACCC to obtain information for monitoring
purposes, including inquiries, are provided under s. 32, together with penalties for non-compliance. The ACCC cannot prevent increases but can report its concerns to the relevant Minister under the Act as part of its monitoring and reporting role.

6.169 In considering the nature of the threat embodied in the Government policy, it is worth noting that the Government made a similar threat when implementing prices oversight arrangements in 1998 for Phase 2 airports. In explaining why prices monitoring for Phase 2 airports pursuant to s. 27A of the PSA was necessary, the Treasurer noted that:

*Price monitoring will allow the ACCC to collect data where the airport operator may have scope to exercise market power but where coverage of the services under the more formal price cap arrangements is not considered warranted. Any abuses of market power detected through the prices monitoring arrangements will be the trigger for consideration of stricter forms of prices oversight.* (Costello 1998)

6.170 A further PC recommendation that was accepted by the Government was that quality monitoring of regulated services should continue at major airports including Sydney Airport\(^\text{23}\). In accepting this recommendation, the Government stated that:

*The Commission also proposes that quality of service outcomes be published on an annual basis as part of the broader reporting requirements under price monitoring. The Government agrees that these outcomes should also be taken into account in the review of airport price regulation, which is to be completed towards the end of the five year regulatory period (see Recommendation 6).* (Anderson and Costello 2002)

6.171 This statement makes clear that the threat of re-regulation applies not just to price regulation but also the regulation of quality standards. As noted above at paragraphs 6.2 and 6.158, SACL may exercise its market power not just through monopoly pricing but also through the imposition of other terms and conditions of access that may result in the extraction of monopoly returns. The threat of re-regulation in relation to quality standards may temper SACL’s incentive to exercise market power in such a way.

6.172 DOTARS regularly monitors and reports on trends in the aviation industry, which enables the Government to react quickly to any signs

\(^{23}\) Quality of service monitoring at major airports (including Sydney Airport) has been in place since 1 July 1997. The regime provides for the ACCC to monitor quality of service pursuant to Part 8 of the *Airports Act 1996*. 
that airport pricing could have an adverse impact on competition in the airline industry. This could also have a tempering effect on SACL's incentive to exercise market power across the range of its services.

6.173 As noted above at paragraph 6.161, the PC considered that the credible threat of re-regulation, the imposition of prices monitoring and the continuing threat of declaration under Part IIIA would constrain the exercise of monopoly power by an airport. In relation to the threat of declaration under Part IIIA, the Council does not consider that this is a sufficient constraint on the exercise of a monopoly service provider's market power such that criterion (a) would not be satisfied. To conclude otherwise would defeat the purpose of declaration under Part IIIA.

6.174 The Council does, however, accept that there is a credible threat of re-regulation faced by airports that distinguishes the sector from other monopoly service industries. This is because airports have recently emerged from a regulated environment of price caps and prices notification, and are cognisant of the implications (particularly in respect of the costs of operating in a more regulated environment) that would arise from re-regulation. In addition, there is a clear threat from the Government that it will reimpose more heavy-handed regulation if light-handed regulation was considered to be ineffective in addressing market power. Finally, this threat is made more credible by the prices monitoring scheme under the PSA currently operating in respect of aeronautical services for a five year probationary period. The prices monitoring regime expressly provides for information relating to pricing and market conduct to be gathered by the ACCC. This information will be used to assess the need for re-regulation at the end of the five year probationary period.

6.175 Airports are currently operating in the probationary period identified by the Government as the time it will be assessing the need for more heavy-handed re-regulation. The proximity of the threat together with the fact that the probationary period commenced relatively recently further suggests that the threat of re-regulation particular to airports is a real constraint on the exercise of market power.

6.176 In its draft determination, the Council considered that the threat of re-regulation would constrain SACL's incentive to exercise market power to a greater extent than the constraint from non-aeronautical revenue, but the operation of the dual constraints would not be sufficient to completely negate SACL's incentive to exercise market
power. The Council had little information on which to determine the likely trigger point.

6.177 In response to the Council’s draft recommendation, Bluestone Consulting (acting on behalf of Melbourne Airport) noted that in May 2002, Melbourne Airport (and it is believed other airports) were involved in numerous discussions with DOTARS, the Commonwealth Treasury and various Ministers as to what sort of conduct would be acceptable under the new airports regulatory regime. It was made clear to Melbourne Airport that price rises in the order of 100 per cent were unacceptable. Bluestone Consulting argues that the ‘upper limit of SACL’s capacity to increase prices without attracting Government intervention is probably around 15% possibly less’ (Melbourne Airport 2003b, p. 14).

6.178 The PC submitted:

In most cases, airports have negotiated price agreements with airlines. In several instances, medium-term agreements have been negotiated which cover service quality, consultation procedures, and airport investment.

On the basis of the evidence so far, the new arrangements appear to be generally working satisfactorily. (PC 2003, p. 2)

6.179 In its response to the Council’s draft recommendation, DOTARS considered that:

the evidence to date supports a view that the Government’s policy approach is working well.

The major airports have responded to light handed regulation in the manner anticipated. Melbourne, Brisbane and Perth Airports have entered into pricing agreements, based on efficient pricing principles, that give the airports and airlines pricing certainty, comfort on quality and quantity of service levels and that provide for required investment in an orderly manner.

It is understood that Sydney Airport Corporation Ltd (SACL) is moving to negotiate a similar agreement with stakeholders following approval of its master plan. The Department is of the view that there is no evidence to suggest that Sydney Airport has not engaged in commercial negotiations in good faith or that there has been unreasonable price increases. (DOTARS 2003b, p. 6)

6.180 DOTARS also noted that Government has a spectrum of responses to influence any inappropriate pricing behaviour by airports before re-regulation is required as a ‘last resort’. Among these, the Government reserved the right to bring forward the five-year review,
or conduct a separate review, if it appeared there had been unjustifiable price increases (DOTARS 2003b).

6.181 While there is no indication at what level of unjustified airport charge increases the Government would intervene to re-regulate, the Council notes that the Government explicitly requires the ACCC to object to unjustified price increases greater than the CPI for regional airlines (see paragraph 6.80).

6.182 On the basis of the new information it has received, the Council considers that the threat of re-regulation, while not an absolute constraint on the exercise of market power by SACL would act as a significant constraint on SACL’s conduct. Even though there is a range of pricing practices and other conduct that SACL could engage in without necessarily resulting in adverse price monitoring findings by the ACCC under the PSA, other avenues are available for monitoring the behaviour of airports. As such a small unjustifiable increase in the price for the Airside Service, and/or other charges, could result in criticism from the Government and a real possibility of re-regulation.

6.183 The Council considers that the threat of re-regulation, in combination with the constraining effect non-aeronautical revenue, would constrain SACL’s incentive to exercise market power. While the operation of the dual constraints might not be sufficient to completely negate SACL’s incentive to exercise market power, it provides a strong incentive for SACL maintain prices close to competitive levels for non-regional domestic airlines.

6.184 The Government’s explicit requirement for the ACCC to object to unjustified price increases greater than the CPI for regional airlines provides an absolute constraint on SACL’s ability to exercise market power in the narrower regional airline market.

6.185 As noted in paragraph 6.149, the degree to which declaration promotes competition in the Domestic Passenger Market must be material. For criterion (a) to be met, the Council must conclude that the adverse effect on competition of SACL exercising its market power up to the level at which the threat of re-regulation constrains its power, is material.
Evidence that SACL is exercising market power to adversely affect competition

6.186 Evidence that SACL has exercised its market power to detriment of competition would demonstrate that the impact is material.

6.187 Criterion (a) is concerned with an assessment of the structure of the dependent market rather than specific conduct of the monopoly service provider. If, taking into account the structure of the dependent market, access facilitated by declaration would promote competition in that market, criterion (a) is satisfied.

6.188 Evidence that a monopoly service provider has engaged in conduct that constitutes an exercise of monopoly power to adversely affect competition will, however, demonstrate that the monopoly service provider has the requisite market power for the purpose of criterion (a). While evidence of conduct is sufficient to establish the requisite exercise of market power, it is not necessary to satisfy criterion (a). This is because criterion (a) is concerned with the structure of the dependent market.

6.189 Evidence that a monopoly service provider has exercised market power may also assist in demonstrating the extent to which the exercise of market power would adversely affect competition, and as such, the degree of benefit that would flow from declaration.

6.190 Both Virgin Blue and SACL provided the Council with extensive arguments in relation to whether particular conduct that SACL has engaged in or intends to engage in is evidence of an exercise of market power for the purpose of criterion (a). BARA, in response to the Council’s draft recommendation, also commented on SACL conduct. These arguments are set out below.

6.191 In considering whether SACL’s behaviour to date is evidence of an exercise of monopoly power for the purpose of criterion (a), the Council is cognisant of the fact that Sydney Airport has recently moved out of a price regulated operating environment (see paragraph 6.199). This leads to the difficulty of not having competitive or non-regulated benchmarks against which to assess the particular conduct concerned. In addition, evidence that SACL has not exercised market power to date, is not conclusive of whether it will not do so in the future.
6.192 Evidence that SACL has engaged or is engaging in monopoly pricing, that is, by charging prices substantially above competitive prices, is a clear indicator of an ability and incentive to exercise monopoly power to adversely affect competition. It is very difficult, however, to estimate competitive prices to use as a benchmark for assessing whether a service provider is monopoly pricing.

6.193 SACL’s aeronautical charges were subject to approval by the ACCC under the PSA prices notification regime until 1 July 2002. The ACCC determined these charges principally on the basis of a reasonable rate of return on assets. The last ACCC price determination for aeronautical services charges at Sydney Airport under this prices notification regime was in May 2001. The intention of such price regulation was to establish a price that approximated a competitive outcome. While regulation is ‘a second best option to competition’ in terms of determining efficient pricing, the Council considers that in the absence of a competitive market for the provision of aeronautical services, the only indicator of efficient outcomes for such services are the regulated outcomes determined by the ACCC. On this basis, the Council accepts that the price for aeronautical services allowed by the ACCC approximates a competitive outcome.24 The Council does, however, accept that there have been significant changes in the aviation sector and the operating environment of Sydney Airport since the ACCC’s aeronautical services price determination in May 2001, (for example, the collapse of Ansett and the events of 11 September 2001) that may mean that the ACCC determined price is no longer as accurate a proxy of competitive prices today as it was in May 2001.

6.194 In relation to the ACCC pricing decision BARA contends that:

[c]urrent prices for the Airside Service at Sydney Airport are based upon a decision in May 2001 by the Australian Competition and Consumer Commission (ACCC) on a pricing application by SACL. BARA contends that the SACL pricing application was based upon inflated and inefficient operating costs. (BARA 2003d, p. 1)

6.195 BARA, for example, noted that following a review by airlines of SACL’s forecast operating expenditure, SACL presented a revised

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24 See the Tribunal’s discussion on the relationship between competitive outcomes and regulated tariffs in the Duke EGP decision, paras 190-110. See also the remarks of Ordover and Lehr in the Council’s Moomba to Sydney Pipeline recommendation (Ordover and Lehr 2001, p. 19)
pricing proposal to the ACCC's assessment in which it adjusted the operating cost base downward from $71 million to $64.2 million and then later again to $56.4 million for 2000-01.

6.196 BARA also commented that Sydney Airport, as a government owned monopoly, was never subject to a CPI-X price cap. Therefore, it is arguable that Sydney Airport, during the period 1997-2002 was not subject to the same incentives as the privatised airports to minimise costs and operate efficiently.

6.197 SACL has not made any substantive increases in charges for aeronautical services since 1 July 2002. Accordingly, the price SACL currently charges for the Airside Service is substantially the same as the one approved by the ACCC. SACL noted as follows:

*Price adjustments, of several cents, since that date have reflected the outcome of a process for financing new capital works, endorsed by airline users in a consultative committee that includes Virgin Blue.* (SACL 2003a, p. 5)

6.198 SACL also advised the Council that it is currently under-recovering on the cost of its domestic runway aeronautical investments by $10 million due to the down turn in airport traffic since 11 September 2001. SACL argued that if the former PSA prices notification regime continued to apply, this under recovery would entitle SACL to seek an increase in the aeronautical service charges. This may suggest that there is some justification for SACL to increase charges for aeronautical services. As the appropriate size of any such increase is not relevant to the Council's investigations, it has not analysed whether such price increases are warranted and if so by how much.

6.199 Apart from the comments made by BARA, no submission received argued that SACL's current Airside Service charges were above competitive levels. Frontier Economics further noted that:

*It is almost certain that the current prices for aeronautical services are still substantially less than an unregulated profit-maximising monopolist would elect to charge.* (Frontier Economics 2003a, p. 10)

6.200 Virgin Blue submitted that:

*due to complementarities in demand and supply, the regulatory history of charges for the Airside Service and difficulties in accurately determining the actual cost of the Airside Service, there is little benefit in comparing the cost of the provision of the Airside Service to current charges for the Airside Service in any analysis of the market power of SACL.* (Virgin Blue 2003a, p. 20)
Virgin Blue’s evidence of SACL’s use of market power

6.201 Virgin Blue gave three examples of conduct by SACL, which it considered demonstrated that SACL has used or intends to use its market power to adversely affect competition.

(1) Terrorism insurance charge

6.202 Virgin Blue and Frontier Economics referred to SACL’s media release dated 28 February 2003 which announced that it planned to recover a $6 million increase in terrorism insurance by means of a levy on airlines that was subsequently introduced initially for the period between 1 April 2003 and 30 June 2003.

6.203 Virgin Blue and Frontier Economics argued that the pass on of an increase in operating costs in the manner proposed by SACL is not conduct consistent with a firm operating in a competitive market. It argued that only a firm with a substantial degree of power in a market can impose a charge on its customers for costs it had previously under recovered, particularly where it attempts to make up for the whole of this under-recovery in three months (Virgin Blue 2003a, p. 12; Frontier Economics 2003a, pp. 13-14).

6.204 In response, SACL noted that prior to 11 September 2001, terrorism insurance was part of SACL’s base insurance policy. However, since that time, SACL’s terrorism insurance premiums have increased to twice those of all SACL’s other insurances. SACL noted that:

As war and terrorism cover was not previously separately charged, no allowance was made for it as part of SACL’s ordinary baseline operating costs, on which the ACCC calculated SACL’s allowable revenue. Furthermore, the magnitude of these premiums, and the events that led to them, could not have been foreseen when Sydney Airport’s charges were set in May 2001.

The cost of this war and terrorism insurance is clearly of such an extraordinary nature and magnitude that it cannot be reasonably expected to be absorbed by SACL. (SACL 2003b, pp. 3-4)

6.205 SACL also noted that ‘while operating in an apparently competitive industry, airlines have similarly tended to pass on their own additional war and terrorism insurance costs as a passenger surcharge’ (SACL 2003b, p. 4).

(2) No pass through of operating costs reduction

6.206 Virgin Blue noted that SACL reported significant reductions in operating costs yet chose not to pass these savings on to its customers. Virgin Blue argued that this is not conduct consistent with a firm operating in a competitive market (Virgin Blue 2003a, p. 12).

6.207 In response to the Council’s draft recommendation, BARA provided some specific examples that supports Virgin Blue’s argument. BARA notes that the build-up in its workforce in the lead up to the Sydney 2000 Olympic Games was reflected in the operating costs presented by SACL to the ACCC. Until the latest restructure at SACL, that labour force build-up had not been redressed to any significant extent. In April 2003 an analysis by Credit Suisse First Boston (CSFB) identified benchmark cost savings of $40 million at Sydney Airport. UBS Warburg (UBSW) expect Sydney Airport operating expenses per passenger to drop from $5.04 in 2002-03 to $4.32 in 2004-05, a fall of 14%, as a result of the recently announced restructure by SACL (BARA 2003d).

6.208 SACL in responding to Virgin Blue’s submission stated that:

*Sydney Airport’s aeronautical charges approved by the ACCC explicitly provided for aeronautical operating cost savings of 4 per cent per annum in real terms. That is, assuming constant traffic flows, SACL has to achieve real savings of at least this level simply to maintain the rate of profit calculated by the ACCC as providing it with a reasonable return on its airport assets. Importantly, the framework approved by the ACCC did not contemplate that charges would be adjusted to return to, or recover from airlines, any difference between forecast and actual operating costs.* (SACL 2003b, p. 3)

6.209 SACL also noted that it has not sought to pass on a number of increases in operating costs to airlines. In particular, it noted an 81 per cent increase in insurance premiums (in addition to the terrorism insurance) that it did not pass through to airlines (SACL 2003b, p. 3). SACL also advised the Council that in mid 2002, it upgraded Sydney Airport’s east-west runway at a cost of $4.6 million. After initially seeking to recovery this cost from airlines, SACL did not do so, as a negotiated agreement on the matter with airlines was not reached. Finally, as noted in paragraph 6.198, SACL advised the Council that it is currently under-recovering on the cost of its investment in domestic runway aeronautical investments by $10 million. SACL has not sought to recovery this cost from airlines.
(3) **SACL’s change to charging on a per-passenger basis rather than a maximum weight on take off basis**

6.210 Prior to 1 July 2003, the Airside Service was charged on the basis of an aircraft’s maximum take off weight (MTOW). SACL informed airlines that it intended to change its charging basis from MTOW to a per passenger basis and effected this change on 1 July 2003.

6.211 Virgin Blue strongly opposed SACL’s change to per passenger charging for the Airside Service. Virgin Blue estimated that the change will result in an increase in its average charges for the use of runway and associated facilities for a flight to or from Sydney by about 50 per cent (Virgin Blue 2003b, p. 2).

6.212 Virgin Blue noted that its business model relies on growing passenger demand by attracting more price sensitive marginal passengers, that is, passengers that may not otherwise fly in the absence of low fares. Virgin Blue argued that its passenger demand would fall if it were to pass on any increase in charges for the Airside Service. The airline also noted that profitability is a key determinant in deciding whether to offer or expand particular services (Virgin Blue 2003c, p. 4). Any increase in the Airside Service charges may render a route into or out of Sydney unprofitable or less profitable in comparison with other routes. This may result in a withdrawal of services to or from Sydney.

6.213 Virgin Blue further noted that the change to per passenger charging would disproportionately disadvantage it in relation to Qantas. Virgin Blue estimates that for Qantas, the average increase in runway charges resulting from the change will be less than 5 per cent whereas for Virgin Blue, charges would increase by approximately 50 per cent. The reason for this differential is that Qantas aircraft have, on average, a much lower number of passengers per tonne of MTOW when compared to aircraft used by Virgin Blue (Virgin Blue 2003b, p. 2).

6.214 Virgin Blue referred to the ACCC’s comments when it considered a proposal by Sydney Airport to introduce per passenger charging on domestic services in 2001:

> The Commission considers that Virgin Blue’s submission raises important concerns about the impact the domestic passenger charge may have on competition in the domestic aviation market. It appears that the proposed restructure may disadvantage new entrants who carry more passengers per aircraft. However, these complex issues requires greater analysis than what has been
possible in the [Prices Surveillance Act’s] 21 day statutory period. (ACCC 2001b)

6.215 Frontier Economics argued that charging on a per passenger basis is less efficient, as it would:

lead to less-competitive outcomes in the air services market than do weight-based charges. The reason for this is that charging per passenger increases the marginal costs to an airline of taking on an additional passenger. This increase in marginal costs will lead to inefficiently-high prices for passenger services.

Once an airline has scheduled a flight, the opportunity cost to the airline of filling an additional seat is very low (except when the airline is very full). This means that, in competitive markets, the pricing of marginal seats might be very low. By loading landing charges on these marginal seats, airports would be raising the floor on the price of marginal seats offered by airlines.

The conclusion is that airports can affect patterns of competition among airlines not only by raising prices for aeronautical services above competitive levels, but also by affecting the structure of prices. (Frontier Economics 2003a, p. 23)

6.216 In contrast, SACL submitted that the change to per passenger charging would encourage efficiency. SACL noted that:

As the ratio of passengers to aircraft weight generally decreases as aircraft size increases, passenger based charges also remove the present disincentive for airlines to use larger aircraft, thereby promoting more efficient use of potentially constrained airport infrastructure.

Sydney Airport should be pricing its services with a view towards optimising the number of passengers that can be moved within the 80 movement an hour cap. SACL considers that passenger based runway charges are a valuable step towards better utilising the capacity of Sydney Airport. (SACL 2003b, p. 4)

6.217 The Council notes that Sydney Airport is not currently capacity constrained, even at peak times and that SACL does not expect it to be so before 2009 (see paragraphs 5.24 to 5.30). SACL advised the Council that notwithstanding available slot capacity in the short to medium term, it considered that the move to per passenger pricing would delay the expected capacity constraint beyond 2009.

6.218 SACL further argued that the change would in fact be pro-competitive. It noted that the more efficient utilisation of capacity at Sydney Airport as a result of the change ‘would also help to ensure that landing slots are available to provide flexibility for smaller
airlines to expand services to compete more effectively, and to accommodate new entrant airlines’. In addition, ‘[t]he passenger charge will assist airlines by effectively converting runway charges into a variable cost, providing for a sharing of risk between Sydney Airport and airlines on passenger loads’ (SACL 2003b, p. 4).

6.219 SACL referred to the fact that the ACCC allowed the change to per passenger charging for international services at Sydney Airport in 2001. The ACCC noted in its approval that no airline opposed the change and that Sydney Airport had presented it as being revenue neutral (ACCC 2001, pp. 204-5).

6.220 SACL advised the Council that Virgin Blue also accepted per passenger charging for aeronautical services at Hobart, Alice Springs, Darwin, Canberra, Perth and Coolangatta airports. SACL noted that runway charges per arriving and departing passengers at Sydney Airport would be significantly less than those charged at any other domestic airport currently charging on a per passenger basis. SACL also noted that passenger-based charges had not been an impediment to the airline’s ability to compete and expand services as Virgin Blue has introduced new services or significantly increased services to many of the airports that had introduced passenger based charges. Examples included the launching of Sydney to Canberra, Alice Springs and Darwin services as well as doubling of services between Melbourne and Hobart. Figures published in the Bureau of Transport and Regional Economics October 2003 Avline also confirm that demand for airline travel continues to grow despite increased airport charges in Australia. Total domestic and regional passengers increased by 12 per cent from June 2002 to June 2003, for example. The Council notes, however, it is possible that growth in demand could have been higher in the absence of the price increases.

6.221 The Council notes that while SACL considered that the change to per passenger charging would have a ‘transitional impact’ on airlines as they are encouraged to move to larger aircraft, Virgin Blue noted that ‘due to the long term nature of aircraft leases, converting a fleet over to a new type of aircraft would be likely to take at least 10 years’ (SACL 2003b, p. 7; Virgin Blue 2003d, p. 8).

26 SACL noted that charges at Sydney Airport would be (ex GST) $2.88 per passenger compared with Melbourne-$3.17, Perth-$3.60, Hobart-$4.00, Launceston-$4.00, Alice Springs-$4.98, Darwin-$4.98, Coolangatta-$5.36, and Canberra (includes development charge) -$5.51.
Council’s assessment of SACL’s conduct

6.222 The Council is not aware of evidence that SACL is currently charging substantially above competitive levels for aeronautical services. The current charging level and structure is substantially the same as that approved by the ACCC under the prices notification regime in 2001. Further, while the ACCC price determination in 2001 envisaged SACL retaining operating cost reductions for the period for which the price increase approval applied, the Council recognises that such reductions, in part at least, would have been considered in future price increase decisions by the ACCC. Nonetheless, the Council recognises that SACL’s failure to date to pass on operating cost reductions to airlines could reflect the fact that SACL has market power but it is not determinative of an exercise of market power by SACL to adversely affect competition.

6.223 The Council notes Virgin Blue’s argument that the change to per passenger charging for aeronautical services would increase its costs of operating services into and out of Sydney by a substantial degree. It accepts that Virgin Blue may bear a greater burden from the new arrangements. It is not clear, however, Virgin Blue, are less able than Qantas to pass on increased charges. Consequently, the change to per passenger charging may not harm competition on routes to and from Sydney, and therefore, the Domestic Passenger Market generally. These arguments apply to both increases in aeronautical charges as a result of per passenger charging as well as SACL’s pass through of the war and terrorism insurance.

6.224 As noted in paragraphs 6.114 to 6.116, criterion (a) requires a consideration of the effect of declaration on competition as a whole rather than on a particular competitor. In considering Virgin Blue’s arguments that SACL has already exercised or intends to exercise market power to adversely affect competition, the Council considers that while Virgin Blue offers more than a basic airline service it is still a low cost carrier. As such, the competitive impact of the aeronautical charge changes and pass through of war and terrorism insurance would likely have a similar impact on other potential low cost carriers. The Council notes Virgin Blue’s argument in relation to the change to per passenger charging that:

Any such airline would suffer the same cost disadvantage for the use of runway at Sydney Airport compared to Qantas as Virgin Blue does. Virgin Blue notes that these features are key aspects of low fare airlines around the world. Therefore, the proposed changes by SACL would negatively affect the competitive position
of any low fare airline operating out of Sydney Airport. (Virgin Blue 2003d, p. 7)

6.225 On the other hand, SACL argues that the change to a per passenger charging basis is pro-competitive. In particular, the sharing of risk between airlines and SACL for passenger load factors may be appealing to new entrants or other carriers. The Council notes that in general, airlines passed on the war and terrorism insurance to passengers, and that SACL has not passed on to carriers other significant increases in operating costs or sought to recover unexpected shortfalls in revenue.

6.226 On the basis of the information before it, the Council considers that it is unable to determine whether the change to per passenger charging for aeronautical services or the pass through of the war and terrorism insurance, amount to an exercise of market power by SACL.

Impact on competition

6.227 The Council considers that while SACL has the ability to exercise market power, its incentive to do so is constrained by non-aeronautical revenues and the threat of re-regulation. In particular the threat of re-regulation significantly limits SACL’s ability to raise charges above competitive levels. Nevertheless, SACL would have some incentive to raise charges above competitive levels up to the point where the threat of re-regulation imposes a constraint. Consequently the Council has considered whether this will have an adverse impact on competition.

6.228 The Council considered the following considerations relevant in determining whether SACL has the ability to exercise market power to adversely affect competition:

- Sydney Airport is crucial to airlines operating national networks (see paragraphs 6.109 to 6.113);
- Airside Service charges make up between 2 and 10 per cent of final ticket fares;
- there is some scope for airlines to price discriminate when passing on increased charges; and
- passengers at Sydney Airport are in general relatively price inelastic.
In its submission to the Council’s draft recommendation, Virgin Blue argued that an increase in the Airside Service charges ‘would adversely impact on competition in the market because it would have a disproportionate impact on low fare carriers. This was because low cost carriers, such as Virgin Blue, are less able to price discriminate in the way it passed on increases in the Airside Service charges as it carried a greater proportion of more price sensitive passengers (Virgin Blue 2003d). Virgin Blue presented economic modelling analysis from Frontier Economics that suggested a doubling of Airside Service charges would cause a fall in passenger traffic of the order of 2 to 5 per cent.

In preparing its draft recommendation, the Council was presented with little evidence to the contrary. It therefore concluded that an increase in charges for the Airside Service by SACL could adversely affect the commercial operability of low cost carriers such as Virgin Blue. This draft recommendation was based on a finding that:

- the proportion of final passenger fares constituted by Airside Service charges is greater for low cost carriers than for full service carriers;
- low cost carriers are likely to carry a higher proportion of the more price sensitive passengers; and
- low cost carriers are likely to operate on lower margins per route (in order to offer lower fares) making them more commercially vulnerable to increases in airport charges.

As a result increased charges could lead to exit or contraction in the number of services offered on Sydney routes such that competition on Sydney routes would be adversely affected. Given the importance of the Sydney market, an increase in charges for the Airside Service above competitive levels would adversely affect competition in the Domestic Passenger Market as a whole.

Both Virgin Blue and BARA endorsed the Council’s draft recommendation.

In response to the Council’s draft recommendation, SACL sought the advice of Mallesons Stephen Jaques, which considered that the Council had misinterpreted criterion (a) with respect to the Virgin Blue application. In particular, Mallesons Stephen Jaques advised SACL that the Council had:

- not applied the appropriate concept of competition;
• not allowed criterion (a) to have meaningful operation;
• not properly assessed the materiality of any impact on the promotion of competition; and
• not confined its consideration to the promotion of competition rather than the promotion of competitors.

6.233 SACL commented that:

[...]he TPA requires the Council to find affirmatively that declaration would promote the process of competition. As such, we are concerned that evidence presented to the Council regarding market structure is largely anecdotal... (SACL 2003f, p. 4)

6.234 A number of other submissions also provided new evidence that raised doubts about the basis for the Council’s draft recommendation, including those received from Adelaide and Parafield Airports, Professor Forsyth and Melbourne Airport.

6.235 Adelaide and Parafield Airports noted that:

Since de-regulation there have been increases in airport charges but to efficient levels which have had no material effect on demand or competition in domestic services. It is questionable therefore if the analysis of the Virgin Blue submission has been adequately explored and was maybe too dependant on the assertions of Virgin Blue in regard to their assessment of the aviation market and the likely impact on competition. (Adelaide and Parafield Airports 2003, p. 1)

6.236 Peter Forsyth considered that the Council had not assessed the competition issues in enough depth. He essentially argued that the Council had focused too much on low cost carriers without sufficiently considering the impact on full service carriers.

6.237 Melbourne airport considered that the Council’s ‘conclusions have been influenced by some simple, and in some cases incorrect, assumptions about the structure of the domestic aviation market and the business decisions and cost structures of airlines’ (Melbourne Airport 2003b, p. 1).

6.238 In light of the comments and supporting information received the Council has re-examined these issues.

**Importance of airside service charges in airfares**

6.239 The relative importance of airside charges in airfares affects how responsive air travellers are likely to be to a price increase by SACL.
Where airside charges represent only a small proportion of the final ticket price, an increase in SACL’s airside charges may have little effect on final demand.

6.240 In relation to this matter, the PC noted that the use of price discrimination (‘yield management’) by airlines made it difficult to ascertain the proportion of a particular fare comprised by airport charges. The proportion of the fixed costs of operations (including landing charges) that airlines allocate to each customer segment differs. The exact proportion depends on the airport being considered (because charges vary across airports), as well as the particular airfare in question. Airfares in turn depend on the route, carrier and other conditions attached to the ticket, such as discounts for advance purchase.

6.241 The PC received evidence in its inquiry that, for domestic passengers, airport charges comprised 2 to 3 per cent of average airfares and 4 per cent of average costs, while on particular routes this can be lower. For instance, on the Sydney to Melbourne route (the busiest route in Australia), airport charges comprise less than 1 per cent of the total full economy airfare (PC 2002, pp. 128-9).

6.242 In its submission, Virgin Blue stated that the charges imposed by airports for take-off and landing services can amount to up to 10 per cent of Virgin Blue’s commonly offered ticket prices on certain routes into and out of Sydney (Virgin Blue 2003a).

6.243 SACL considered Virgin Blue’s claim to be misleading as it implied a ‘commonly offered’ one way fare of around $29. SACL cited ‘a recent sample of lowest available fares ... on one-month advance purchase being $65 mid-week...’ (SACL 2003f, p. 4)

6.244 Airside charges will be a higher proportion of a discount airfare as compared to full economy fare, whether offered by Qantas, Virgin Blue or any other carrier. An increase in airside charges may reduce an airline’s capacity to offer discount fares. The Council recognises, however, that the overall impact is determined by the spread of discount and full economy airfares. The Council notes that Frontier Economics reported that ‘Virgin Blue would anticipate that average fare is likely to be higher than $100’ (Frontier Economics

27 On the Canberra to Sydney route, for example, in November 2003 on their respective web sites Qantas published a discount rate of $75 and Virgin Blue of $49. The Airside Service charge equates 4 to 6 per cent of these fares.
On this point the PC argued that where airport charges as a proportion of ticket prices may be around 10 per cent, compared with an industry average of three or four per cent, an airport would have an incentive to treat Virgin Blue (or any similar low cost carrier) differently from the mainstream, well-established carrier such as Qantas, in order to increase throughput and airport profits. The only question is whether such discrimination is practicable (PC 2003, p. 4).

Airside charges appear to comprise a relatively low proportion of average airfares, even for low cost carriers, suggesting that the price elasticity of demand for airside services could be relatively low. Accordingly, this would enhance SACL’s ability to raise charges without it having an adverse impact on competition.

**Sensitivity of demand**

The above argument, however, is not inconsistent with an argument that low cost carriers service a greater proportion of more price sensitive passengers. Virgin Blue has reported that its airfares are some 35 to 50 per cent below those of Qantas (CAPPA 2003).

n/e/r/a stated that simple comparison of fares is not in itself sufficient to draw the conclusion that Virgin Blue’s fares are lower on average as published fares give no indication of the number of passengers that are travelling on any particular fare category. In support of this n/e/r/a cited a number of examples such as frequent flyer programs and rebates to corporate customers (SACL 2003f).

While Virgin Blue does not currently operate a frequent flyer program, it does operate corporate accounts. A full analysis of the business operations of Qantas and Virgin Blue may reveal that the true difference between Virgin Blue and Qantas airfares is somewhat narrower. The competitive advantage of a low cost carrier would seem to be dissipated, however, if it were not able to offer lower average fares.

Virgin Blue considered that because it serviced a more elastic component of the market, an increase in the Airside Service charges ‘would adversely impact on competition in the market because it would have a disproportionate impact on low fare carriers such as Virgin Blue.’ This was explained as follows:
Low cost carriers such as Virgin Blue generally have a higher proportion of high elasticity passengers compared with “full service” carriers such as Qantas which, through a higher cost structure, offer additional services for price inelastic travellers such as business travellers...Further, when low fare carriers review the feasibility of particular routes that are being serviced by full service airlines, they generally allow for an overall increase in the number of passengers on the route following their entry on the basis that the lower prices they offer stimulates demand by attracting those price elastic passengers further along the demand curve who would not otherwise have travelled.

Therefore, when airlines are forced to pass on increased charges for the Airside Service, the resultant fall in demand will be highest among the price elastic travellers, and there will be comparatively little fall in demand among price inelastic travellers, and this unequal fall in demand will impact more severely on low fare carriers than on other carriers. (Virgin Blue 2003a, p. 17)

6.251 BARA also made a distinction between the effect of increases in airport charges between different carriers noting that longer haul routes generally attract passengers wanting full service and that:

As a result of those full service passengers, long haul routes generally offer the opportunity to achieve higher yields and demonstrate a somewhat lower price elasticity of demand than experienced on short haul routes almost exclusively servicing leisure destinations. On to the shorter haul leisure routes airlines generally face lower yields and higher price elasticity of demand.

Consequently, any increase in charges for the airside service at Sydney Airport will have differing net effects on different airline markets depending on a range of economic circumstances, including the nature of the market served. Any increase in the charges for the airside service at Sydney Airport will have a relatively greater adverse effect on those routes where airlines experience lower yields and higher price elasticity of demand. Those airlines will be under greater economic pressures to exit the market they service in the event that the charges for the airside service at Sydney Airport are increased. (BARA 2003a, p. 5)

6.252 In its response to questions from the Council, REX noted that:

[E]very route is measured on a monthly basis to monitor profitability, with key factors such as load factor, yield, schedule and operating costs being of greatest importance. A significant shift in any of these factors (say 10-20%) would warrant a review of aircraft type, price or schedule. (REX 2003, p. 2)

6.253 Aeropelican advised the Council that a fare increase of just 10 per cent would be sufficient for passenger numbers to drop sufficiently to
threaten the airline’s commercial operability. This was principally because of the significant inter-modal substitution possibilities on the Sydney to Newcastle route (the only route operated by the airline) offered by road and rail.

6.254 In terms of the impact of an increase in airside charges, Virgin Blue noted that any increase in charges would be passed on to passengers as an increase in fares and/or absorbed by the carrier. Virgin Blue considered that airlines would generally adopt some combination of the two measures. Virgin Blue argued that higher ticket prices would result in a drop in passenger numbers away from competitive levels and that this drop represents a lessening of competition.

6.255 Virgin Blue went on to argue that:

>Airlines make decisions about commencing on a new route or increasing the number of flights on existing routes by comparing the incremental cost of that new route or flight compared with the estimated incremental revenue that could be generated from that new route or flight. The charges imposed by SACL for the Airside Service are an important part of the incremental cost of any flight to or from Sydney Airport, and increases in those charges may result in additional flights to or from Sydney Airport no longer being viable. Alternatively, airlines might decide that certain additional services should be directed to routes not involving Sydney Airport due to the more favourable margins that could be earned on those routes given the increased charges by Sydney Airport for the Airside Service. (Virgin Blue 2003a, pp. 16-17)

6.256 This suggests that low costs carriers and short haul carriers may bear a greater burden of any increase in SACL’s airside charges as demand for their services is likely to be more price sensitive. However, the impact on competition will depend on how readily airlines are able to absorb or pass on an increase in airside service charges.

**Airlines ability to price discriminate**

6.257 The impact on competition in the dependent market of a rise in airside charges would be lessened if airlines may be able to pass on a greater proportion of an increase in the Airside Service charges to its more price inelastic passengers. SACL argued that airport charges ‘are effectively passed on to classes of passenger through airfares that vary with passengers’ price sensitivity’ and that Virgin Blue had not demonstrated that a change in charging structure (see paragraphs 6.210 to 6.213) ‘will have any material effect on its ability to Ramsey price, by segmenting different elements of the air

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passenger transport market and set fares in accordance with the price sensitivity of different categories of traveller’ (SACL 2003b, pp. 4-5).

6.258 In response, Virgin Blue reiterated the arguments referred to above at paragraph 6.117 and argued that it was less able to price discriminate in the way it passed on increases in the Airside Service charges than full service carriers because it carries a greater proportion of more price sensitive passengers (Virgin Blue 2003d).

6.259 Tretheway notes that low cost carriers offer low one-way fares largely limiting price discrimination to the date of ticket purchase and this is an effective mechanism for drawing passengers away from full service carriers, which typically apply return trip and/or minimum and maximum stay requirements to discount fares. In order to compete, the full service carrier is eventually forced to adopt the simpler price discrimination scheme (Tretheway 2003). Qantas has introduced one-way fare pricing, removed its Saturday night and minimum stay restrictions and reduced the number of fares available from ten to five28 (CAPPA 2003).

6.260 The Council also notes that Virgin Blue has been enhancing its ability to price discriminate. It has introduced a range of services designed to attract greater numbers of less price sensitive business passengers29. Virgin Blue offers airport lounges in major cities and seating with additional leg room for those passengers willing to pay more. Virgin Blue now reportedly serves at least 20 per cent of the travel requirements of half of the top 50 companies in Australia.

6.261 While low cost carriers do not cater to high yield business class passengers, other avenues for price discrimination appear similar for both low cost and full service carriers. This implies that the impact of an increase in airside charges may have a more neutral impact on competition than anticipated in the Council’s draft recommendation.

28 A more comprehensive spread of fares is still available on some routes (see table 2).

29 For example: Steve Creedy, “Virgin lounging about for business”, The Australian, 11 April 2003 and Virgin Blue Continues to Soar, Media Release, 15 May 2003; which states that the “airline continues to focus on growing its share of the lucrative corporate travel market”. Virgin Blue also noted in its submission to the ACCC in the Qantas/Air New Zealand alliance authorisation that it is ‘actively targeting business customers. For example, it is considering introducing a frequent flyer program, lounges and valet parking’. (p. 14)
Airline profit margins

6.262 To extent to which airlines may need to alter schedules or withdraw services in response to price increase is largely determined by the profitability of offering a service.

6.263 In response to the Council’s draft recommendation, Professor Forsyth commented that even though many full service carriers have a strong position in high yield markets around the world they have not been as profitable as the low cost carriers (Forsyth 2003).

6.264 The OECD (2000) found that premium class and full fare paying passengers, while representing a minority of travellers, generate a disproportionately large share of airline profits (OECD 2000). Capturing a share of this traffic, therefore, is essential for an airline to be able to compete effectively. In relation to the Australian market, the Centre for Asia Pacific Aviation (CAPPA) reports that the price sensitivity of Virgin Blue’s passengers dictates that many seats are sold at discounted rates. To do this, however, and offer relatively low full fares (35 to 50 per cent below Qantas’s) implies it sells a higher proportion of economy full fares than Qantas. If this were not the case, its cost advantage would be eroded by a substantially lower yield profile (CAPPA 2003).

6.265 SACL notes that Virgin Blue’s estimated earnings per plane are US$5.3 million, US$4.4 million higher than Qantas, and that Virgin Blue is among the world’s most profitable airlines (SACL 2003f). Indeed, in a recent press statement, Sir Richard Branson claimed that Virgin Blue’s margins will always be above Qantas (Branson 2003).

6.266 Consequently, although low cost carriers may cater to more price sensitive segment of business and leisure travellers, it is not clear that they operate on lower margins than full service carriers and are therefore are less able to absorb increases in airport charges than full service carriers.

Materiality of the impact of an increase in airside charges

6.267 Virgin Blue provided the Council with economic modelling analysis from Frontier Economics which estimated the impact of a change in the Airside Service charges on SACL’s total revenue and passenger numbers by taking into account (among other things) the effect of passenger price elasticity and the total proportion of fares made up of the Airside Service charges. (The analysis is considered in more
Based on indicative numbers, the analysis suggests that if charges for the Airside Service were to double, passenger traffic would fall in the order of 2 to 5 per cent.

6.268 In response to the Council’s draft recommendation, SACL further contended that ‘[e]ven where charges are passed on to passengers, the effect on passenger tickets is very different from the dollar-to-dollar relationship assumed by the NCC’ (SACL 2003f, p. 4). SACL presented analysis from n/e/r/a to demonstrate that when increases in Airside Service applied only to high yield passengers, the fall in demand would be more modest. The model results, which took into account the differences in price elasticities of demand and fares paid by high yield and discount passengers, indicate that a 25 per cent increase in charges at would result 0.2 per cent drop in passenger numbers.

6.269 Indeed, the Council’s further investigation of the issue raises some doubt that low cost carriers are less able than full service carriers to price discriminate. Consequently, the Council would expect the impact on the dependent market to be smaller than that modelled by Frontier Economics.

6.270 Moreover as discussed in paragraphs 6.159 to 6.195, the Council has received new information that indicates that relatively small increases in charges may be sufficient for the Government to consider re-regulation. It is not clear therefore that SACL has an ability to raise charges to the extent indicated by Frontier Economics or, indeed, n/e/r/a.

6.271 On the basis of the new information presented to it, the Council considers that the impact of an increase in charges for the Airside Service by SACL is likely to fall more heavily on low cost carriers as overall the Airside charge is likely to represent a higher proportion of airfares. It is not clear, however, that low cost carriers have less capacity than full service carriers to absorb a price increase or price discriminate in the way they pass on any cost increases to their passengers so as to minimise effects on demand. Consequently, it is unclear that the impact on low cost carriers will be greatly different from the impact on full service carriers. It is not clear to the Council that even a significant increase in airside charges (100 per cent for example) would have such a material impact on demand as to lead to a possible exit or contraction in the number of services offered on
Sydney routes such that competition on Sydney routes, and hence the Domestic Passenger Market, would be adversely affected.\(^{30}\)

**Conclusion on the Domestic Passenger Market**

6.272 While the Council considers that SACL has an ability and incentive to exercise market power, there is sufficient constraint on SACL's ability to exercise its market power to prevent it raising prices substantially above a competitive level. Some increase in prices above competitive levels may result in monopoly rents. Airlines, however, have some capacity to price discriminate which would lessen the impact on demand and reduce efficiency losses from the increase in charges.

6.273 On the information available to it, the Council cannot be satisfied that SACL's constrained ability and incentive to exercise market power will have a material adverse affect on competition on routes into and out of Sydney. Given Sydney Airport's importance to the Domestic Passenger Market as a whole, the same conclusion applies in respect of the Domestic Passenger Market (see paragraphs 6.109 to 6.113).

**Air freight markets**

6.274 As noted in paragraph 6.93, the geographic dimension of the market may be appropriately defined in terms of city or regional centre pairs.

6.275 As noted in paragraph 6.45, the supply of air freight capacity is provided in two forms: as belly-hold capacity on passenger aircraft, and through space on dedicated freighters. In Australia, belly-hold capacity is the most significant source of air freight capacity in domestic air freight markets. For the reasons set out in paragraphs 6.60 to 6.61, the main driver influencing the supply of air freight

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\(^{30}\) See *Virgin Blue Continues to Soar*, Media Release, 15 May 2003 where Brett Godfrey, Chief Executive of Virgin Blue, states that 'Virgin Blue has demonstrated the potential of our low fare model. It is the industry's high-growth sector and it continues to deliver acceptable returns despite challenging operating conditions'. Also see Qantas and Air New Zealand application to the Commerce Commission NZ, in which they note the inevitable growth of the low cost sector. See *Notice Seeking Authorisation*, 9 December 2002, pp. 7–8

www.comcom.govt.nz/adjudication/qantasairnz.cfm
capacity is the demand for passenger services rather than the demand for freight.

6.276 The Council concludes that there are sufficient constraints to prevent SACL from exercising market power to such an extent that access facilitated by declaration would not necessarily promote competition in relation to passenger services into and out of Sydney Airport, including regional services and domestic services that feed into international air passenger services. Given that passenger services to and from Sydney are the main determinant of the supply of air freight services to and from Sydney, it follows that the Council’s conclusion that declaration would not promote competition in relation to passenger services into and out of Sydney, applies equally to those air freight routes into and out of Sydney that do not face effective inter-modal competition.

6.277 Accordingly, the Council cannot be satisfied that on the narrowest market definition for freight, that is, air freight routes into and out of Sydney, access to the Airside Service facilitated by declaration would promote competition in those air freight markets that do not face effective inter-modal competition. As such, criterion (a) would not be satisfied in respect of those markets.

**Conclusion on criterion (a)**

6.278 On the basis of the information available to it, the Council cannot be satisfied that SACL’s ability and incentive to exercise market power is such that it would cause a material adverse effect on competition in any of the identified relevant dependent markets.

6.279 The Council concludes criterion (a) is not met.
7 National significance

s. 44G(2)(c) The facility is of national significance having regard to:

(i) the size of the facility; or

(ii) the importance of the facility to constitutional trade or commerce; or

(iii) the importance of the facility to the national economy.

Background

7.1 Section 44G(2)(c) of the TPA (criterion (c)) is a test of materiality, placing less important facilities outside the scope of Part IIIA. While declaration is concerned with access to services rather than facilities, criterion (c) relates national significance to the facility providing the service.

7.2 In identifying infrastructure of national significance, the Council considers the matters listed in criterion (c). A facility needs to satisfy only one of the three benchmarks listed. There is considerable overlap, between the second and third benchmarks.

Size

7.3 The physical dimensions of a facility may provide guidance on whether it is of national significance. Relevant indicators of size include physical capacity and the throughput of goods and services using the facility.

 Constitutional trade or commerce

7.4 Section 44B of the TPA defines ‘constitutional trade or commerce’ to mean trade or commerce:

(a) among the States;

(b) between Australia and places outside Australia; or
7.5 The importance of the facility to constitutional trade or commerce may be indicated by the monetary value of trade that depends on the facility, or the importance of the facility to trade or commerce in related markets. In considering whether Sydney Airport was of national significance in the Sydney Airport decision the Tribunal observed that in-bound and out-bound freight worth more than $21 billion was cleared at Sydney Airport in 1997 (Sydney Airport decision, para 208).

Importance to the national economy

7.6 In assessing the importance of a facility to the national economy, the Council focuses on the market(s) in which access would promote competition. National significance is established if the dependent market(s) provide substantial annual sales revenue to participating businesses. In the Sydney Airport decision, the Tribunal emphasised the importance of Sydney Airport to ‘Australia’s commercial links with the rest of the world’, noting that 50 per cent of air freight enters and leaves the nation through Sydney Airport (Sydney Airport decision, para 208).

The application

7.7 In its application, Virgin Blue submitted that there is ‘little question’ that Sydney Airport is of national significance in satisfaction of criterion (c). In support of its submission, Virgin Blue noted:

(a) the comments of the Tribunal in Re Sydney International Airport when considering the same question with regard to Sydney Airport, namely that it is “beyond doubt that the facility is of national significance” (para 207) (although the Tribunal in that matter was more concerned with the freight operations carried out through Sydney Airport);

(b) the data on passenger traffic and aircraft movements through Sydney Airport set out in its application; and

(c) the comments of SACL that:

(i) Sydney Airport is one of the major employers in Sydney, directly providing 33,500 jobs and a further 33,000 jobs through flow-on effects; and

(ii) Sydney Airport generates approximately $3.5 billion in economic benefits to the Sydney region and a further $3.8
billion in flow-on effects in New South Wales. (Virgin Blue 2002, p. 10)

Assessment

7.8 The Tribunal was satisfied that Sydney Airport satisfied criterion (c):

The evidence before the Tribunal ... make [sic] clear the predominant and pervasive role that SIA [Sydney International Airport] plays in Australia’s commercial links with the rest of the world. In 1997 in-bound and out-bound freight to a value exceeding $21 billion was cleared at SIA. Evidence was given that 50% of the airfreight into and out of Australia goes through SIA and approximately 80% of the airfreight which goes through SIA is carried by passenger aircraft. The Tribunal is affirmatively satisfied that the facility provided by SIA is of national significance for the purpose of s44H(4)(c). (Sydney Airport decision, para 208)

7.9 In the past the FAC has expressed the view that:

Sydney Airport plays a key role in the economic and social well being of Sydney, NSW and Australia. It is the gateway for a booming tourism industry, a growing international business capability and a significant contributor to trade in Australia. Sydney Airport is an economic hub and proudly supports the employment of some 66,500 jobs directly and indirectly, approximately 8% of Sydney's total workforce. International travel for both inward and outward travellers has an enormous impact on the well being of the Sydney community. (FAC 1997, p. 35)

7.10 BARA cites the State Chamber of Commerce (New South Wales), which expressed the view that Sydney Airport:

is the single most important piece of transportation infrastructure in Australia and plays a strategic role in the economy of Sydney and the nation. (BARA 2003a, p. 6)

7.11 The Council received no submissions that argued that Sydney Airport was not of national significance for the purposes of criterion (c).

7.12 BARA stated that:

Sydney Airport is also important to the economic prosperity of the city of Sydney and Australia as a whole. It is the primary international gateway for tourists and business travellers, with over 9 million international traveller arrivals and departures in
2002. Sydney Airport is also the major gateway to Australia’s largest city and business community. (BARA 2003a, p. 7)

7.13 Adelaide Airport noted in its submission that ‘[t]here is no doubt that Sydney Airport is of national significance being a major economic driver for the Sydney Metropolitan Area’ (Adelaide Airport 2003, p. 3). Similarly, Melbourne Airport noted in its submission that it ‘seems plain that airside services provided by the nation’s largest airport are of national significance’ (Melbourne Airport 2003, p. 4).

**Conclusion**

7.14 The Council concludes that Sydney Airport is of national significance. Accordingly, the application satisfies criterion (c).
8 Health and safety

s. 44G(2)(d) Access to the service can be provided without undue risk to human health or safety.

Background

8.1 The rationale for s. 44G(2)(d) (criterion (d)) is that declaration should not occur where access or increased access to a service provided by a facility may pose a legitimate risk to human health or safety.

8.2 Some facilities require a degree of spare capacity to provide appropriate safety margins. In addition, access to facilities may need to be governed by conduct codes and operational guidelines. For a service to be declared, access must be possible without compromising system and operational integrity, and safe scheduling or timetabling must be feasible.

8.3 Criterion (d) does not refer to increased access specifically, but to access generally. If access is being provided, then this should not be automatically construed as evidence that access is being provided safely. The Council must still be satisfied that access can be provided without undue risk to human health or safety (Sydney Airport decision, paras 210–11).

8.4 The existence of relevant safety regulations may satisfy criterion (d) where these regulations deal appropriately with any safety issues arising from access to the service provided by the facility. Alternatively, criterion (d) may be satisfied where the terms and conditions on which access is provided could address any safety concerns raised by access to the service.

8.5 In considering criterion (d) in the Sydney Airport decision, the Tribunal concluded that the significant potential for accidents of serious dimensions on aprons and surrounding areas could be addressed by including in the terms and conditions for the provision of access to any ramp handler:

(a) an obligation to satisfy strict safety requirements; and

(b) the right for SACL to apply appropriate and enforceable sanctions on any operator who breaches those requirements.
8.6 The Tribunal stated that s. 44G(2)(d), if applied at Sydney Airport:

*would in practice see the terms and conditions of access for any ramp handler - whether they are agreed by negotiation or determined by independent arbitration - include enforceable provisions as to operational safety.* ((Sydney Airport decision, para 214)

8.7 Accordingly, if the terms and conditions of access can appropriately address safety concerns, then criterion (d) may be satisfied. The safety requirements and their enforcement may be left to the second stage of the two-stage process of obtaining access to the service: the negotiation or arbitration stage.

**The application**

8.8 Virgin Blue submitted in its application that it is unaware of any reason why access to the Airside Service cannot be provided without undue risk to human health or safety. (Virgin Blue 2002, p. 11)

**Assessment**

8.9 In the Sydney and Melbourne Airports Part IIIA declaration applications, the Council considered (among other things) the nature of existing safety regulations, the potential for accidents given the manner in which access would be provided and the extent to which access would add to congestion on freight aprons. The Council concluded that access would not pose additional safety concerns to those risks that may already exist. (NCC 1997, pp. 44-51)

8.10 The Council did not receive any submissions that argued that access to the Airside Service at Sydney Airport could not be provided without undue risk to human health or safety.

8.11 On this matter, BARA submitted that:

*The Sydney Airport Conditions of Use require airlines, when using the airport, to comply with inter alia:*

(a) *all legislation,*

(b) *the SACL Airport Operations Manual,*

(c) *the SACL Airport Security Program,*

(d) *local flying restrictions,*
(e) directions on security from the Commonwealth Department of Transport and Regional Services.

The Conditions of Use also require that airlines will not do anything that puts SACL in breach of any legislation and that airlines accept that:

(a) access to SACL facilities and services is subject to the demands of other users of the airport, and

(b) use of the airport is constrained by legislation.

BARA submits that the wider legislative provisions governing the use of Sydney Airport by airlines and the airport operator ensure that access to the service can be provided without undue risk to human health and safety. (BARA 2003a, p. 8)

8.12 Melbourne Airport noted in its submission that it:

can see no way in which declaration could lead to a situation that would lead to undue risk to human health or safety given that any arbitration ultimately made by the ACCC can in no way obstruct aviation safety regulations which flow primarily from the Civil Aviation Act 1988. (Melbourne Airport 2003, p. 4)

8.13 Adelaide Airport submitted that ‘[p]rovided that compliance to mandated standards is adhered to and audited in a competent manner controlled airside access should not have any undue risk to health and safety.’ (Adelaide Airport 2003, p. 4)

8.14 The Council agrees that the terms and conditions of access to the Airside Service can appropriately address safety concerns.

Conclusion

8.15 The Council considers that access to the Airside Service can be provided without undue risk to human health or safety. The Council therefore concludes that the application satisfies criterion (d).
9 Effective access regime

s. 44G(2)(e) Access to the service is not already the subject of an effective access regime.

Background

9.1 Infrastructure services already covered by an effective access regime cannot be declared under Part IIIA. The main purpose of s. 44G(2)(e) (criterion (e)) is to allow State or Territory governments to develop industry-specific access regimes compliant with the Competition Principles Agreement (CPA) that apply to the exclusion of Part IIIA.

9.2 The term ‘effective access regime’ is not defined in the TPA. Some guidance as to its meaning can be found in s. 44G(3) which provides that when considering whether an access regime established by a State or Territory amounts to an effective access regime, the Council must apply the relevant principles in the CPA.

9.3 There is no certification procedure for Commonwealth and private access regimes and Part IIIA provides no legislative indication of how to assess the effectiveness of such regimes. Rather, as stated in the Explanatory Memorandum to the Competition Policy Reform Bill 1995, which enacted Part IIIA, the Council has a broad discretion in assessing the effectiveness of Commonwealth and private access regimes:

Where the access regime applying to a facility is established by a State or Territory that is a Party to the Competition Principles Agreement, the Council must apply the guiding principles for access regimes set out in that Agreement in considering whether that regime is effective or not. In other cases, the Council is free to determine how it assesses the effectiveness of an access regime - it might, for example, consider the outcomes produced by that regime. (Gear 1995, para 176)

9.4 In considering the effectiveness of such a regime, the Council has regard to:

(a) whether outcomes produced by the regime are efficient;

(b) the legal enforceability of the regime by all interested persons; and
whether the regime reflects the principles set out in clause 6 of the CPA. (clause 6 principles)

9.5 The requirement for legal enforceability makes it unlikely that a private regime could be regarded as effective. Private infrastructure owners have the option, however, of submitting an access undertaking to the ACCC for approval. A service cannot be declared where it is the subject of an access undertaking approved by the ACCC, as per ss. 44G(1) and 44H(3) of the TPA.

The application

9.6 Virgin Blue submitted that there is no access regime relating to the Airside Service that satisfies the criteria for an effective access regime within the meaning of criterion (e).

9.7 Virgin Blue noted in its application that even though the landing rights at Sydney Airport are governed by the Sydney Airport slot management scheme, the scheme does not govern all the terms and conditions of access to the Airside Service (such as landing and apron parking fees) and as such, does not satisfy criterion (e) as an effective access regime (Virgin Blue 2002, p. 11).

9.8 Virgin Blue also noted that pursuant to the lease of Sydney Airport from the Commonwealth to SACL, SACL is required to operate the Sydney Airport site as an airport and provide access to the airport by intrastate, interstate and international air transport. However, Virgin Blue submitted that this obligation does not provide any access rights to third parties, such as a right to have an access dispute determined by an independent arbitrator, and as such would not amount to an effective access regime within the meaning of Part IIIA of the TPA (Virgin Blue 2002, p. 12).

Assessment

9.9 There is no State or Territory access regime covering Sydney Airport that has been determined as effective under ss. 44M and 44N of the TPA.

31 Sydney Airport Demand Management Act 1997 and related regulations.
32 Clause 3 of the Airport Lease for Sydney (Kingsford-Smith) Airport.
9.10 The Council must therefore consider whether the existing Sydney Airport access provisions constitute an effective access regime for the purpose of criterion (e).

Slot Management Scheme

9.11 The *Sydney Airport Demand Management Act 1997* imposes a legislative cap on aircraft movements for Sydney Airport through a slot management scheme (SMS). The SMS caps jet aircraft movements at the airport at peak times to 80 per hour. This is intended to better utilise the available runway capacity at Sydney Airport and to ameliorate the impact of noise on areas surrounding the airport. Slots are allocated and managed by Airports Coordination Australia (ACA) – an entity which is jointly owned by the airports and airlines. ACA operates independently of SACL. Each season, of which there are two a year, ACA assesses slot availability and allocates slots according to requests lodged by airlines (SACL 2003a, p. 2).

9.12 Airlines holding slots are able to maintain these across seasons based on closely defined ‘grandfathering’ rights.

9.13 The SMS does not distinguish between slot use for domestic and international flights. A distinction is made, however, for the purpose of regional (that is, intrastate) services. Under regional ring fencing provisions, slots grandfathered for regional services can only be swapped with slots for interstate and international services within 30 minutes of their originally scheduled time. This ensures that peak time regional slots are effectively protected. Currently, approximately one third of peak hour slots are ring-fenced for use for regional services (SACL 2003a, p. 2; SACL 2001a, p. 1).

9.14 Virgin Blue considers that as the SMS does not govern all the terms and conditions of access to the Airside Service (such as landing and apron parking fees) it does not constitute an effective access regime for the purposes of criterion (e). SACL did not submit that the SMS amounts to an effective access regime.

9.15 The Council considers that the SMS does not constitute an effective access regime for the purposes of criterion (e). This is because the SMS does not cover all necessary terms and conditions of access. Nor does it reflect many of the principles set out in the Clause 6 principles such as the need for a legally enforceable dispute resolution mechanism.
Leases and general conditions of use

9.16 Prior to privatisation, long-term domestic terminal lease agreements between the FAC and the incumbent airlines, Qantas Airways and Ansett, were re-negotiated. Among other things, the re-negotiated lease agreements required the incumbent airlines to make gates at their terminals at some core-regulated airports available to new entrants – this included two terminal gates at Sydney Airport (PC 2002, p. 63). The Council understands, however, that all third party access rights to areas leased under domestic terminal lease arrangements were extinguished by 30 October 2000.

9.17 As a result, Sydney Airport, as with most of the larger Australian airports, has developed general conditions of use, which set out the commercial and operational conditions for use of airport facilities. A potential new entrant airline could obtain access to Sydney Airport facilities under the airport’s general conditions of use.

9.18 SACL did not submit that its conditions of use constituted an effective access regime for the purposes of criterion (e).

9.19 BARA submitted that SACL’s conditions of use do not constitute an effective access regime because they do not reflect the Clause 6 principles on at least two counts:

First, the current access regime does not provide for an enforcement process.

Second, the current access regime does not require a dispute resolution body, in deciding the terms and conditions for access, to take account of:

(a) the owners legitimate business interests and investment in the facility,

(b) the costs to the owner of providing access, including any costs of extending the facility but not costs associated with losses arising from increased competition in upstream or downstream markets,

(c) the economic value to the owner of any additional investment that the person seeking access or the owner has agreed to undertake,

(d) the interests of all persons holding contracts for the use of the facility,

(e) firm and binding contractual obligations of the owner or other persons (or both) already using the facility,
(f) the operational and technical requirements necessary for the safe and reliable operation of the facility,

(g) the economically efficient operation of the facility, and

(h) the benefit to the public of having competitive markets. (BARA 2003a, pp. 12-13)

9.20 The Council agrees. SACL's general conditions of use do not govern all the terms and conditions of access to the Airside Service. It does not refer to whether outcomes produced are efficient, nor provide for the legal enforceability of the regime by access seekers. The conditions of use do not appropriately reflect the Clause 6 principles. The Council therefore considers that the Sydney Airport conditions of use do not constitute an effective access regime for the purposes of criterion (e).

Other access obligations

9.21 SACL noted in its submission that it is required under the terms of its airport lease from the Commonwealth to provide access to the airport for intrastate, interstate and international air transport services. SACL also noted that it has obligations under the facilitation guidelines promulgated by the International Civil Aviation Organisation (ICAO) to allow access (SACL 2003a, p. 2). SACL stopped short, however, of asserting that its airport lease and ICAO access obligations amount to an effective access regime for the purposes of criterion (e).

9.22 SACL's obligations to provide access under its lease and ICAO obligations do not provide for the determination of the terms and conditions of access. Nor is there any mechanism for the resolution of access disputes in a legally enforceable and effective manner. Accordingly, SACL's lease and ICAO access obligations do not reflect the Clause 6 principles and cannot be considered effective under criterion (e).

9.23 Virgin Blue noted in its submission that the Minister's Declaration 90 made pursuant to s. 21(1) of the Prices Surveillance Act 1983 (PSA) provides that the supply of certain aeronautical services to regional airlines are notified services for the purpose of the PSA. The effect of this is to place some restrictions on the ability of SACL to raise prices for the Airside Service for regional services. Before it increases these prices it must first notify the ACCC of such a price increase and must not increase the price of that service until the proscribed period has elapsed (21 days), or the ACCC has provided
notice that it does not object to the new price. Virgin Blue submitted that this does not constitute an effective access regime as it does not provide to any person a right of access, rather it is a prices surveillance regime (Virgin Blue 2003a, p. 21).

9.24 The Council agrees with Virgin Blue’s submission that PSA coverage does not in itself amount to an effective access regime under criterion (e).

9.25 The Council does not consider that, taking all of the access mechanisms currently in place for Sydney Airport as a whole (that is, the SMS, the airport conditions of use, SACL’s lease and ICAO obligations and the PSA declaration), the package of existing access measures amounts to an effective access regime under criterion (e). All of the existing mechanisms suffer from similar deficiencies; namely, they do not cover all necessary terms and conditions of access, do not provide for effective and legally binding dispute resolution mechanisms and do not provide for a general enforceable right of access by any person. As a whole, the existing measures do not reflect the Clause 6 principles and cannot be considered to form an effective access regime for the purpose of criterion (e).

**Conclusion**

9.26 The Council concludes that the Airside Service provided by SACL is not the subject of an effective access regime. Accordingly, the application satisfies the requirements of criterion (e).
10 The public interest

s. 44G(2)(f) Access (or increased access) to the service would not be contrary to the public interest.

Background

10.1 Section 44G(2)(f) (criterion (f)) requires that access (or increased access) to the service would not be contrary to the public interest. The Council has received extensive arguments from participants to this process on the public interest case for declaration. Where criterion (a) is not met, that is, declaration is not likely to promote competition in the dependent market it follows that declaration is not in the public interest. While this means the Council does not need to come to a conclusion on this issue, an explanation of how the Council assesses criterion (f) and the arguments presented to the Council that enable an assessment of criterion (f) are set out below.

10.2 In the Duke EGP decision, the Tribunal clarified the interpretation of the public interest criterion under the Gas Code:

Criterion (d) does not constitute an additional positive requirement which can be used to call into question the result obtained by the application of pars (a), (b) and (c) of the [coverage] criteria. Criterion (d) accepts the results derived from the application of pars (a), (b) and (c), but enquires whether there are any other matters which lead to the conclusion that coverage would be contrary to the public interest. (para 145)

10.3 In the Sydney Airport decision, the Tribunal approached the assessment of criterion (f) by first affirming, in effect, the presumption that declaration is in the public interest where criteria (a) to (e) are satisfied. The Tribunal stated:

For the reasons we have already set out in some detail, the Tribunal is satisfied that declaration of the services will promote competition in the ramp handling market. The Tribunal is of the view that it is in the public interest that competition be promoted in this market for the reasons to which we have already referred. (para 219)

33 Criterion (d) under the Gas Code is drafted in similar terms to s. 44G(2)(f).
10.4 The test under criterion (f) is whether there are any matters, other than those addressed by the other criteria, which would lead to the conclusion that declaration would be contrary to the public interest.

10.5 The Council adopts a broad view of the types of matters that may raise public interest considerations under criterion (f), including the costs of regulation, and any effects that regulated access might have on the environment, regional development, and equity.

10.6 In considering whether the costs of regulation following declaration outweigh the benefits, the Council notes that because criterion (f) is phrased in the negative, a recommendation not to declare where criteria (a) to (e) are satisfied would require that the costs of regulated access must outweigh the benefits of regulating natural monopoly services with substantial market power. The extent of these benefits depends on the likely effect on competition in related markets of regulating natural monopoly services; issues considered under criterion (a).

**The application**

10.7 Virgin Blue submitted that in relation to the application for declaration of the Airside Service, declaration would be in the public interest due to the competition that would be promoted through declaration (including in the Sydney Domestic Market). Virgin Blue knows of no reason why declaration would be contrary to the public interest (Virgin Blue 2002, p. 15).

**Assessment**

10.8 The Council considers there to be two main issues in respect of criterion (f). The first is the extent to which declaration would be contrary to the public interest because it may conflict with government policy. The second issue is whether the costs outweigh the benefits of declaration.

**Government policy on airport price regulation**

10.9 The Commonwealth Government on 1 July 2002 implemented price monitoring arrangements for a probationary period of five years to replace price caps and prices notification for some airports, including Sydney Airport. This followed the recommendations of the
Productivity Commission (PC) inquiry into price regulation of airport services (PC 2002). The Government’s press release stated that:

[I]t was always the Government’s intention that airports and stakeholders should commercially negotiate pricing outcomes on aeronautical and aeronautical-related services. The Government agrees that there is merit in supporting the development of commercial agreements. However, it is not clear that the Government needs to, or should, play a role in preparing guidelines for the conduct of those negotiations or the content of particular agreements that may take various forms and cover any variety of matters. The Government is conscious of the costs that would arise from a highly prescriptive regulatory process and considers that it is the parties affected that are best placed to determine these matters in a manner that suits their particular operational needs. (Anderson and Costello 2002)

10.10 In accepting the PC’s recommendation, the Government concluded that under price monitoring, airports would engage in effective commercial negotiations that would improve the efficiency of airport operations. The Government stated that:

Sufficient time needs to be given for the airports and stakeholders to bed down a commercially negotiated operating environment. In that regard there is an expectation that airport operators will implement transitional arrangements that are mindful of the impacts on the industry from adopting efficient pricing principles, and will negotiate with stakeholders a path by which they may be achieved over time. (Anderson and Costello 2002)

10.11 SACL referred to the Government’s preference for light-handed regulation and argued that:

Had the Government intended that all airport charging decisions be subject to ACCC arbitration, clearly it would not have chosen to deregulate airport charges. (SACL 2003a, p. 6)

10.12 SACL further argued that in the absence of any misuse of market power, ‘declaration of Sydney Airport facilities at this time would be inconsistent with the Government’s public policy intent of price deregulation’ and that:

it would be inappropriate to invoke the [Part IIIA] regulatory safeguards, and thereby deny SACL, airport users, and the community the benefits expected to be derived from price deregulation, including reduced administrative costs and better investment decisions under relative regulatory certainty. (SACL 2003a, p. 6)
Virgin Blue argued that the mere expression of the Government’s approach to airport services price regulation by the executive is not in itself determinative of the public interest for the purposes of criterion (f) (Virgin Blue 2003a, p. 22). Virgin Blue stated:

*if an expression of policy by the executive or by the Productivity Commission was allowed to be determinative of, or influential in the consideration of, criterion (f), then this would amount to granting the executive and the Productivity Commission the effective ability to determine that particular facilities were outside the scope of Part IIIA of the Act without any amendment to the provisions of the Act through parliament. All that would be required would be a statement of policy from the executive that the government’s approach in relation to a particular facility was to adopt “light handed” regulation.* (Virgin Blue 2003a, p. 22)

The Government supported the PC’s recommendations that Part IIIA should apply to airport services, including those at Sydney Airport, instead of an industry specific access regime such as that embodied in s. 192 of the *Airports Act 1996*. After stating the Government’s preference towards commercially negotiated outcomes (see paragraph 10.9), the Government went on to say:

*In the event that commercial agreement cannot be concluded in relation to access terms and conditions, the access provisions in Part IIIA of the TP Act provide recourse to arbitration for determining those conditions for 'declared' services.*

and further:

*the Government agrees that all airports should be subject to the generic access provisions of Part IIIA of the TP Act.* (Anderson and Costello 2002)

Virgin Blue also referred to the Government’s recognition of the continued application of Part IIIA by stating that:

*the Government considers that the continued application of Part IIIA, and therefore the declaration of the Airside Service under Part IIIA, is consistent with its support of ‘light-handed price regulation’ at Sydney Airport and its other policy objectives.* (Virgin Blue 2003a, p. 22)

In its submission, SACL acknowledged that the access regime under Part IIIA of the TPA is ‘an important safeguard against misuse of market power, and was recognised as such by the Government in its decision to deregulate charges’ (SACL 2003a, p. 6).

The Council also received submissions which argued that declaration under Part IIIA would undermine, in a manner contrary to the
public interest, the five-year probationary period for the price monitoring regime supported by the Government by effectively not giving it a chance to work.

10.18 SACL stated:

*In seeking recourse to [the Part IIA] regulatory safeguard so early in the probationary period of deregulation, Virgin Blue’s proposal for declaration is inconsistent with the spirit of the Government’s public policy.* (SACL 2003a, p. 6)

10.19 Melbourne Airport, argued that there had not been sufficient time to commercially negotiate access in relation to services at Sydney Airport:

*Whilst progress has been smoother in some than others have [sic], robust commercial negotiations cannot be seen as an abuse of market power or a failure of policy ... in relation to the services Virgin Blue seeks to have declared at Sydney Airport, there appears to be no dispute - in this case, the new arrangements not only have not been given a chance to work, they have not even been required to work.* (Melbourne Airport 2003, p. 6)

10.20 WAC submitted that:

*the new regime has only been in place for 8 months, and should operate for the full five-year probationary period, recommended by the Productivity Commission, before assessing whether more regulation is required.* (WAC 2003, p. 5)

10.21 SACL stated:

*The Government has set out criteria for the assessment of airport behaviour under deregulation, and the threat of the reintroduction of the burdens of regulation provide a significant incentive not to misuse market power.* (SACL 2003a, p. 6)

10.22 SACL quoted the Government by noting that that while Part IIA was retained as a safeguard, ‘the Government intended [Part IIA] to provide “protection for access seekers that have been unreasonably denied access to services”’ (SACL 2003d, p. 7).

10.23 The provisions of Part IIA do not require that an applicant for declaration demonstrate that access has been denied or that the service provider has actually exercised market power to the detriment of competition. Part IIA is concerned with market structure and whether declaration will promote competition by unlocking access to a bottleneck service (see paragraph 2.11).
10.24 The Government’s policy of light-handed regulation is clear; the objective being to facilitate efficient outcomes through commercial negotiation under the regulatory umbrella of prices monitoring and a credible threat of re-regulation. The Council recognises that there is a clear cost associated with not allowing this policy to operate fully by declaring services during the five year probationary period. This cost is considered in detail below.

10.25 The Council, however, recognises that the Government intended that Part IIIA continue to apply to airports during this probationary period. Accordingly, the Council does not consider that declaration under Part IIIA in itself is contrary to the Government’s policy.

Costs of access regulation

10.26 The Council recognises that there are costs associated with declaration of the Airside Service at Sydney Airport. These costs include the benefits forgone as a result of not allowing the current light-handed regulatory approach to operate for the probationary period of five years, indirect costs such as the costs of distorting efficient investment or production decisions, and direct costs of access regulation such as the cost of the arbitration process in the event of an access dispute.

PC view on regulatory approach

10.27 The PC’s recommendations were based on its analysis of the costs and benefits of continuing with the price cap regulatory regime under the Prices Surveillance Act 1983 (PSA) applicable to certain core-regulated airports (but not Sydney Airport where prices were subject to the prices notification regime under the PSA) and other forms of regulation. While the PC’s analysis is distinct from the Council’s analysis of the costs and benefits of declaration for the purposes of criterion (f), the Council considers it worthwhile setting out the PC’s key conclusions on this issue.

10.28 The terms of reference of the PC required it:

\[\text{to examine whether new regulatory arrangements, targeted at those charges for airport services or products where the airport operator has been identified as having most potential to abuse market power, are needed to ensure that the exercise of any such power may be appropriately counteracted. (PC 2002, p. 343)}\]
10.29 The PC concluded that Sydney Airport had significant market power. As discussed in the context of criterion (a), the PC also concluded that the importance of non-aeronautical revenue, the threat of re-regulation and the continuing threat of declaration under Part IIIA would temper SACL’s incentive to exercise its market power. Notwithstanding the tempering effect of these factors, the PC concluded that some form of regulation was required to further constrain SACL’s market power. The issue for the PC was whether a price cap regime was warranted to achieve this objective. (PC 2002, p. 355)

10.30 The PC concluded that a price cap regime was not warranted and recommended a five year price monitoring regime in its place. In so concluding, the PC stated that:

*The Commission has not been persuaded, however, that there is a strong case for the continuation of price caps at any privatised core-regulated airports. This is for two principal reasons.*

*The first is the ever-present risk of regulatory failure, given the severe information problems confronting any regulator. Setting price caps inevitably entails detailed regulatory assessment of, and involvement in, airport operations and investment decisions. It should therefore be used only where the potential efficiency costs of abuse of market power are significant. Even then there is a risk that regulation will cause its own distortions to production and investment decisions. While the Commission agrees that some transitional problems with current price-cap arrangements may have been settled, and that the price caps proposed under [the price cap option] should reduce regulatory involvement in investment decisions, the risk of regulatory failure remains high. This risk has been amplified by the uncertainty that currently pervades global aviation markets.*

*The second and related reason is that the ‘problem’ to be addressed does not warrant such a heavy-handed regulatory regime. Though the four largest airports have considerable market power, the prospect of them using that power in a way that would generate significant costs to the economy or community is supported neither by the evidence nor the analysis. There are strong commercial incentives pulling in the other direction, including scope for increased profits in non-aeronautical activities from increasing passenger volumes, and incentives to discriminate and differentiate in pricing.* (PC 2002, p. 355)

10.31 The PC went on to state that:

*On balance, therefore, the Commission considers that while the undoubted market power of the four major airports [Sydney, Melbourne, Brisbane and Perth airports] warrants some form of*
regulatory constraint, the continuation of price caps is not the best approach. [The price monitoring option] offers a much better regulatory mechanism for promoting the principles for regulation identified in the terms of reference. The ultimate objective — to ensure efficient long-term provision of airport services — is common to both options. In the Commission’s view, [the price monitoring option] provides a greater chance that this objective will be achieved, by providing a better balance between regulatory constraint and promotion of commercial relationships. (PC 2002, p. 355)

Benefits forgone through declaration

10.32 The PC concluded that the most effective manner in which to address the market power of airports was through the facilitation of commercial agreements in an environment of price monitoring and the threat of re-regulation. The Government accepted this approach.

10.33 The Council considers that declaration would cut short the opportunity for this approach to work by effectively introducing the prospect of the ACCC arbitrating terms and conditions of access in the event of an access dispute, well before the end of the five year probationary period during which the effectiveness of the light-handed regulatory approach would be assessed. The costs of doing so include the benefits forgone by foreclosing the opportunity for commercially negotiated outcomes to be achieved in the light-handed regulatory environment.

10.34 In considering these foregone benefits, the Council recognises the unique position of Sydney Airport. There are a number of factors that combine to set it apart from other infrastructure services. Sydney Airport is a natural monopoly but, as discussed under criterion (a), the threat of re-regulation in particular tempers the incentive for SACL to exploit its market power.

10.35 Sydney Airport is in transition from a government owned enterprise subject to a detailed prices notification process to a private entity now operating in a prices monitoring regulatory environment. The Council recognises that SACL needs to plan how to deal with medium to long term future airport congestion, and a dynamic aviation industry characterised by a significant amount of instability and uncertainty.

10.36 The PC similarly noted that the airport sector has a history of government ownership and prescriptive regulation, a complex service mix and dynamic market conditions. It recognised that these
characteristics make it likely that the charging structures in place at the time may not have been the most efficient given the future needs of the industry (PC 2002, pp. 257-8).

10.37 The PC described some of the benefits of encouraging more flexible pricing structures for airports as follows:

In its October 2000 price proposal, SACL (2000) made further changes aimed at aligning prices with costs and also to improve the efficiency of use of congested facilities. The Commission considers that such developments in pricing offer important improvements in the efficiency of use of airport facilities, particularly at an often congested facility like Sydney Airport. More flexibility in pricing and operations should help bring forth the greater efficiency benefits from privatisation.

Specific charges for use of facilities, such as aerobridges, provide airport users with the appropriate information for making efficient decisions about consuming particular services. Time-based charges for use of scarce capacity, such as apron space, dissuade excessive use of the facility and encourage more efficient methods of operation, ration existing capacity to those who value it most and provide appropriate investment signals to the airport operator to expand capacity where possible. (PC 2002, pp. 257-258)

10.38 The PC envisaged that prices monitoring would allow such price flexibility to develop while providing sufficient regulatory oversight to address market power concerns. It concluded that the uncertain outlook for the aviation market since September 2001 called for a more flexible approach and supported the claim by SACL that:

the move away from price notification will actually enhance airports’ ability to conclude commercial agreements with airlines. (SACL 2001b, p. 2)

10.39 The PC identified potential costs to consumers associated with a failure to allow the full benefits of airport privatisation to be realised. It noted that:

the full benefits of privatisation of airports are unlikely to be realised if commercial relationships between airports and airlines continue to be heavily conditioned by intrusive price regulation. The ongoing need for substantial investments at major airports requires a more commercial and cooperative approach. The potential for regulation unduly to constrain prices poses a real risk and one that could impose significant costs on consumers in the future. (PC 2002, p. 357)

10.40 The Council accepts that commercial negotiations against the background of the price monitoring regime and the prospect of re-
regulation are likely to allow SACL to be more innovative and flexible in its development of terms and conditions of access including pricing, during this period of change and uncertainty. The benefits of this have not yet been fully realised because there has been insufficient time since Sydney Airport was privatised to allow new arrangements to be negotiated and implemented. Declaration at this time may prevent further benefits being realised through commercial negotiation subject to the light-handed regulatory regime. The opportunity to test whether light-handed regulation is sufficient to effectively address SACL’s market power would also be lost.

Regulatory failure, indirect and direct costs

10.41 The PC considered the costs associated with price cap regulation in its inquiry (PC 2002). In the case of airports with significant market power such as Sydney Airport, the PC identified a number of costs of such price regulation. The first significant cost was the risk of regulatory failure; that is, the costs associated with the regulator setting an inappropriate price cap. The setting of an inappropriate price cap may distort efficient investment and production decisions by, for example, removing incentives to efficiently invest in new infrastructure or by encouraging inefficient over-investment or over-production. The PC concluded that the risk of regulatory failure and the allocative and dynamic efficiency costs of such failure would be high under a price cap regulatory regime (PC 2002, p. 355).

10.42 The regulatory costs identified by the PC pertained to a price cap regime rather than the regulatory framework that would apply under Part IIIA. The Council considers that while there would be indirect costs in regulating under Part IIIA (through negotiation and arbitration), these would not be as significant as those identified by the PC.

10.43 SACL referred to NECG’s identification of the risk of regulatory error as being ‘efficiency costs to society of incorrect decisions by regulators about whether and how to intervene.’ Such costs include diminished incentives to invest, a constrained ability for infrastructure providers to price efficiently, encouraging inefficient investment in related markets, and wasteful strategic behaviour by producers and consumers seeking to enhance their position through arbitrated outcomes rather than through commercial negotiation (SACL 2003d, p. 2).
10.44 The inefficiency associated with regulatory gaming was noted by SACL. In the context of the regulatory process leading up to the ACCC’s May 2001 Sydney Airport price determination, SACL noted that:

> Arguably SACL and airlines all engaged in wasteful regulatory ‘gaming’ during this process. Rather than engaging meaningfully with one another to negotiate a satisfactory pricing outcome, aspects of submissions to the ACCC took strategic positions and presented extreme views with the aim of securing a better, arbitrated outcome. (SACL 2003d, p. 3)

10.45 Similarly, WAC submitted that declaration would be contrary to the public interest because airlines would have an incentive not to reach agreement through commercial negotiations in order to get to arbitration. This is because airlines know that if they collectively disagree with a particular proposal, then it is likely that the proposal will be rejected by the ACCC. Such a view is based on WAC’s perception of the previous regulatory investment framework administered by the ACCC. (WAC 2003, p. 4)

10.46 In addition to the risk of regulatory failure and the prospect of indirect costs, the Council also considers the direct costs of access regulation. The direct costs of declaration primarily relate to the cost of the arbitration itself. For example, the costs of providing information and preparing arguments in the course of an arbitration.

10.47 WAC submitted that declaration of the Airside Service at Sydney Airport would lead to regulatory control costs that result in greater price increases to consumers, resulting in a net negative impact to consumers. WAC estimated the total cost of the May 2001 SACL Aeronautical Pricing Proposal at around $10 million from all participants, or the equivalent of 5.5 per cent of the allowable revenue determined by the ACCC for aeronautical services at Sydney Airport during 2000/01. Additional to these 5-yearly regulatory costs, WAC estimates annual economic regulatory compliance costs in the order of $2-3 million for all industry participants. (WAC 2003, p. 3)

10.48 SACL submitted that its direct costs incurred as part of the ACCC pricing review that culminated in the May 2001 revision to Sydney Airport’s charges were in the order of $3 million. SACL also referred to estimates by the New Zealand Commerce Commission that ‘the direct costs of price regulation for a single airport are in the order of NZ$1.1m to $2.2m in a price review year, and NZ$0.5m to $1.1m in other years.’ (SACL 2003d, p. 1)
10.49 The ACCC raised concerns that the costs identified by WAC were based on hearsay evidence, not independently verified and may include expenses such as the cost of lobbying the government (which is not a regulatory cost). Further, both WAC and SACL had failed to take into account the fact that many of the costs they had identified would be incurred in the context of commercial negotiations within an unregulated environment (ACCC 2003).

10.50 The Council recognises that there are direct costs associated with declaration. Some of the direct and indirect costs commonly associated with regulation, however, may be incurred in any case in an unregulated environment; for example, the costs incurred by parties involved in commercial negotiations for access to services.

**Costs versus benefits**

10.51 Regulation should only be used where the total cost of regulation is less than would arise in the absence of regulation, notwithstanding an imperfectly competitive market. As Starkie concluded:

> At the end of the day, therefore, there is a trade-off between living with imperfect regulation or with imperfect markets. It is only when the market does not work well, when there is a clear case of natural monopoly and when regulation can reasonably be expected to improve matters that the regulatory option is worthwhile. Market imperfections alone are not a sufficient justification for intervention. (Starkie 2002, p. 64)

10.52 In its consideration of criterion (a), the Council concluded that it was not satisfied that competition would be promoted by regulated access. Declaration would not, therefore, lead to material benefits. The Council has identified a number of potential costs and is satisfied that the costs of regulating the Airside Service outweigh the benefits.

**Conclusion**

10.53 The Council is not satisfied that access would not be contrary to the public interest and concludes that criterion (f) is not met.
11 Exercise of residual discretion

11.1 The Council has a residual discretion not to recommend declaration even though all of the criteria set out in s. 44G(2) are satisfied. This residual discretion includes consideration of the matters set out in s. 44F(3) and s. 44F(4).

Section 44F(3): Application not in good faith

11.2 Section 44F(3) states that the Council may recommend that the service not be declared if the Council thinks the application was not made in good faith. The subsection does not limit the grounds on which the Council may decide to recommend that the service not be declared.

11.3 In regard to an application being made in good faith, DOTARS notes that:

\[\text{the merits for making the application may be viewed in the context of the commercial events applying at the time, as that can provide an indication of whether the application was submitted in “good faith”}.\]

\[\text{SACL, for example, notes that it has not frustrated but rather actively facilitated access through the construction of a common-user terminal}….\]

\[\text{Virgin Blue’s decision to lodge an application with the Council coincided with its court action to attempt to enforce an alleged agreement with SACL that provided dedicated access to half of the available gates (9) at the former Ansett terminal.}\]

\[\text{It could appear that the perceived effect of making the application with the Council was to add leverage to the commercial position of the airline in obtaining concessions from Sydney Airport as to the number of gates and terms on which they would be provided}. (\text{DOTARS }2003\text{b, p. }17)\]

11.4 No other submission received by the Council argued that Virgin Blue’s application for declaration of the Airside Service had not been made in good faith, although the issue of Virgin Blue using the declaration process to gain commercial advantage in negotiations with SACL was raised.
11.5 The Council notes DOTARS and other submissions. The Council does not, however, consider that this means that the application was not made in good faith. Most, if not all applicants, for declaration will be seeking a commercial advantage from making such applications.

11.6 The Council does not need to consider whether the application was made in good faith, given its conclusions on criteria (a) and (f).

Section 44F(4): Consideration of alternative facilities

11.7 Section 44F(4) requires the Council to consider whether it would be economical for anyone to develop another facility that could provide part of the service. This issue is related to but distinct from the consideration of natural monopoly under criterion (b). The Council considers that s. 44F(4) forms part of its residual discretion; that is, where the Council is affirmatively satisfied that all the criteria are met, it may still recommend against declaration if it considers that it would be economical for anyone to develop another facility that could provide part of the service.

11.8 In the case of Virgin Blue’s application, the issue is whether it would be economical for anyone to develop another facility to provide part of the Airside Service. The Airside Service is defined to include the use of runways, taxiways and parking aprons necessary to allow domestic aircraft to take off and land, and move to/from passenger terminals at Sydney Airport. These assets are highly complementary and it is difficult to see how an alternate facility could be economically developed to provide only part (as opposed to the whole) of the Airside Service. For example, if an aircraft lands at Sydney Airport, it could only feasibly disembark passengers at Sydney Airport passenger terminals. Similarly, if passengers are processed through Sydney Airport passenger terminals, they could only feasibly board aircraft that are to take off from Sydney Airport.

11.9 Given the high degree of complementarity between the assets making up Sydney Airport and the nature of the Airside Service, the Council considers that it is not economical for anyone to develop another facility that could provide part of the service. Accordingly, section 44F(4) is not satisfied.
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Appendix A – Sections 44F & 44G of Part IIIA

Section 44F: Person may request recommendation

44F(1) [Written application to Council] The designated Minister, or any other person, may make a written application to the Council asking the Council to recommend under section 44G that a particular service be declared.

44F(2) [Council must act] After receiving the application, the Council:

(a) must tell the provider of the service that the Council has received the application, unless the provider is the applicant; and

(b) must recommend to the designated Minister:

(i) that the service be declared; or

(ii) that the service not be declared.

44F(3) [Application not in good faith] If the applicant is a person other than the designated Minister, the Council may recommend that the service not be declared if the council thinks that the application was not made in good faith. This subsection does not limit the grounds on which the Council may decide to recommend that the service not be declared.

44F(4) [Consideration of alternative facilities] In deciding what recommendation to make, the Council must consider whether it would be economical for anyone to develop another facility that could provide part of the service. This subsection does not limit the grounds on which the Council may decide to recommend that the service be declared or not be declared.

44F(5) [Withdrawal of applications] The applicant may withdraw the application at any time before the Council makes a recommendation relating to it.
Section 44G: Limits on the Council recommending declaration of a service

44G(1) [Access undertakings] The Council cannot recommend declaration of a service that is the subject of an access undertaking in operation under section 44ZZA.

44G(2) [Council to be satisfied of matters] The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters:

(a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;

(b) that it would be uneconomical for anyone to develop another facility to provide the service;

(c) that the facility is of national significance, having regard to:
   (i) the size of the facility; or
   (ii) the importance of the facility to constitutional trade or commerce; or
   (iii) the importance of the facility to the national economy;

(d) that access to the service can be provided without undue risk to human health or safety;

(e) that access to the service is not already the subject of an effective access regime;

(f) that access (or increased access) to the service would not be contrary to the public interest.

44G(3) [Effective access regimes] In deciding whether an access regime established by a State or Territory that is a party to the Competition Principles Agreement is an effective access regime, the Council:

(a) must apply the relevant principles set out in that agreement; and

(b) must not consider any other matters.

44G(4) [Council to follow Minister’s decision] If there is in force a decision of the Commonwealth Minister under section 44N that a
regime established by a State or Territory for access to the service is an effective access regime, the Council must follow that decision, unless the Council believes that, since the Commonwealth Minister's decision was published, there have been substantial modifications of the access regime or the relevant principles set out in the Competition Principles Agreement.
Appendix B – Competition Principles Agreement (extract)

6(2) The regime to be established by Commonwealth legislation is not intended to cover a service provided by means of a facility where the State or Territory Party in whose jurisdiction the facility is situated has in place an access regime which covers the facility and conforms to the principles set out in this clause unless:

(a) the Council determines that the regime is ineffective having regard to the influence of the facility beyond the jurisdictional boundary of the State or Territory; or

(b) substantial difficulties arise from the facility being situated in more than one jurisdiction.

6(3) For a State or Territory access regime to conform to the principles set out in this clause, it should:

(a) apply to services provided by means of significant infrastructure facilities where:

(i) it would not be economically feasible to duplicate the facility;

(ii) access to the service is necessary in order to permit effective competition in a downstream or upstream market; and

(iii) the safe use of the facility by the person seeking access can be ensured at an economically feasible cost and, if there is a safety requirement, appropriate regulatory arrangements exist; and

(b) incorporate the principles referred to in subclause (4).

6(4) A State or Territory access regime should incorporate the following principles:

(a) Wherever possible third party access to a service provided by means of a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access.

(b) Where such agreement cannot be reached, governments should establish a right for persons to negotiate access to a service provided by means of a facility.

(c) Any right to negotiate access should provide for an enforcement process.

(d) Any right to negotiate access should include a date after which the right would lapse unless reviewed and subsequently extended; however, existing contractual rights and obligations should not be automatically revoked.
(e) The owner of a facility that is used to provide a service should use all reasonable endeavours to accommodate the requirements of persons seeking access.

(f) Access to a service for persons seeking access need not be on exactly the same terms and conditions.

(g) Where the owner and a person seeking access cannot agree on terms and conditions for access to the service, they should be required to appoint and fund an independent body to resolve the dispute, if they have not already done so.

(h) The decisions of the dispute resolution body should bind the parties; however, rights of appeal under existing legislative provisions should be preserved.

(i) In deciding on the terms and conditions for access, the dispute resolution body should take into account:
   (i) the owner’s legitimate business interests and investment in the facility;
   (ii) the costs to the owner of providing access, including any costs of extending the facility but not costs associated with losses arising from increased competition in upstream or downstream markets;
   (iii) the economic value to the owner of any additional investment that the person seeking access or the owner has agreed to undertake;
   (iv) the interests of all persons holding contracts for use of the facility;
   (v) firm and binding contractual obligations of the owner or other persons (or both) already using the facility;
   (vi) the operational and technical requirements necessary for the safe and reliable operation of the facility;
   (vii) the economically efficient operation of the facility; and
   (viii) the benefit to the public from having competitive markets.

(j) The owner may be required to extend, or to permit extension of, the facility that is used to provide a service if necessary but this would be subject to:
   (i) such extension being technically and economically feasible and consistent with the safe and reliable operation of the facility;
   (ii) the owner’s legitimate business interests in the facility being protected; and
   (iii) the terms of access for the third party taking into account the costs borne by the parties for the extension and the economic benefits to the parties resulting from the extension.

(k) If there has been a material change in circumstances, the parties should be able to apply for a revocation or modification
of the access arrangement which was made at the conclusion of the dispute resolution process.

(l) The dispute resolution body should only impede the existing right of a person to use a facility where the dispute resolution body has considered whether there is a case for compensation of that person and, if appropriate, determined such compensation.

(m) The owner or user of a service shall not engage in conduct for the purpose of hindering access to that service by another person.

(n) Separate accounting arrangements should be required for the elements of a business which are covered by the access regime.

(o) The dispute resolution body, or relevant authority where provided for under specific legislation, should have access to financial statements and other accounting information pertaining to a service.

(p) Where more than one State or Territory regime applies to a service, those regimes should be consistent and, by means of vested jurisdiction or other co-operative legislative scheme, provide for a single process for persons to seek access to the service, a single body to resolve disputes about any aspect of access and a single forum for enforcement of access arrangements.
Appendix C - Submissions

16. ACCC - letter to Council in regard to Sydney Airport submission on regulatory costs, June 2003.

Submissions on Council draft recommendation:

17. Peter Forsyth, Professor of Economics, Monash University, August 2003.


Responses to the Council’s invitation for more submissions

27. Sydney Airports Corporation Ltd (SACL), September 2003.
