5 February 2003

Ms Deborah Cope
Acting Executive Director
National Competition Council
GPO Box 250B
MELBOURNE VIC 3001

Dear Ms Cope

**Application by Virgin Blue for Declaration of Airside Services at Sydney Airport**

Australia Pacific Airports Corporation (APAC) is company owned by AMP Henderson Global Investors, Deutsche Capital Partners, BAA plc and Hastings Funds Management. It has a 100% interest in the company (Australia Pacific Airports (Melbourne) - APAM) that holds the airport lease at Melbourne Airport and a 90% interest in the company (Australia Pacific Airports (Launceston) - APAL) that hold the airport lease at Launceston Airport.

As the Council would be aware, price and access regulation of infrastructure services is matter that has been subject to extensive discussion at both a state and federal level over the last few years. In particular, the Productivity Commission has conducted three inquiries that have been of direct relevance to airports

- Review of the *Prices Surveillance Act 1983* (Report 14)
- Review of the National Access Regime (Report 17); and
- Price Regulation of Airport Services (Report 19)

These three reports (and in particular Report 19) and the submissions made to them contain a wealth of material on the structure, conduct and performance of the Australian airports sector. More importantly, however, the Commonwealth Government’s response to Report 19 must be seen as the current, definitive statement on airport price regulation policy. It has formed the basis on which airports and airlines have entered into discussions about a range of access issues (price, quality, capacity, consultation, payment terms, insurance, liability and so on). From these discussions, commitments on capital expenditure have been made and in the case of Melbourne Airport, five-year contracts have been entered into for the provision of aeronautical services and in the case of Virgin Blue, a ten-year terminal licence has also been concluded.

Obviously any recommendations the Council may make in relation to declaration of services at any major airport in Australia has the potential to create uncertainty about arrangements at other major airports entered into by parties in good faith taking
government policy as set out in the Government’s response to Report 19. If declaration occurs in Sydney it may flow on to at least Melbourne and Brisbane and potentially Adelaide and Perth. Therefore, we believe that there is a very strong public interest argument against declaration for the reasons set out below and that declaration is unlikely to alter competitive conditions in any other market. Accordingly the Council should not recommend declaration of the relevant services.

We see the principal questions in this matter revolve around the criteria in sections 44G(2) (a) and (f). Before turning to those matters, it is helpful to look in somewhat more detail at the reasons for the application, the definition of the services for which declaration is sought and the other criteria set out in section 44(G).

Background to the Application

The ACCC has previously indicated it believes in relation to declaration under section 192 of the *Airports Act 1996* that “in defining the service and identifying the facilities in question, it considers it appropriate to have regard to the nature of the dispute”.

Clearly, the genesis of Virgin Blue’s application was the dispute over access to T2 (the old Ansett domestic terminal) at Sydney Airport immediately after the sale of Sydney Airports Corporation Limited to the Southern Cross Consortium. Subsequent to resolution of that dispute, Virgin Blue withdrew that part of its application that related to terminal services but is continuing with its application in relation to airside services.

At this time, there appear to be no matters in dispute between the parties. This is very different to the ACTO matter previously considered by the Council and is different in its legal form to issues considered by the Council in relation to the gas industry.

We also make the observation that there appears to be no suggestion made that Sydney Airport is seeking to deny Virgin Blue or any other airline access to the services in question. It seems that Virgin Blue’s motivation in seeking declaration stems from a concern that in the absence of declarations under section 21 of the *Prices Surveillance Act 1983*, Sydney Airport may increase its prices and that it may move to passenger based charges for the provision of airside services for domestic services. Certainly in relation to the aggregate level of prices, we are not aware of any suggestion that Sydney Airport is considering price increases of the magnitude it was previously allowed by the ACCC.

It is a matter of record that of all the price increases that have occurred at major airports in Australia in recent years, the largest was that which occurred when services were declared under the *Prices Surveillance Act 1983* at Sydney Airport. The increases that have occurred at Melbourne, Brisbane and Perth since the Government accepted the Productivity Commission’s recommendations are much lower in percentage terms than was the case in Sydney and have led to prices significantly lower than those charged in Sydney. In other words, the price outcomes that have occurred under the deregulated environment have been more advantageous to airlines than those that occurred under the ACCC’s stewardship.

---

The reason for this is simple. When the ACCC considered Sydney's price application, Sydney Airport was experiencing significant losses on its aeronautical business on an earnings before interest and tax (EBIT) basis. Whilst aeronautical EBIT was at least positive at other major airports, returns on assets were still well below the bond rate, let alone the cost of capital, in all cases. Both in the Sydney case and other more recent negotiations in the deregulated environments, price increase have largely been directed at correcting this situation and providing stable price paths to fund investment in the coming years. These price increases, in particular the ACCC's decision in relation to Sydney Airport, should be seen as one off adjustments to move prices to efficient levels, rather than as Virgin Blue suggests a sign of intent on the part of airports to pursue price increases inconsistent with normal pricing principles or government policy.

Virgin Blue is also concerned about Sydney Airport moving to passenger based charges. Seeking declaration to prevent this seems to us to be bordering upon vexatious given that Virgin Blue has agreed to this as the basis of charging in both Melbourne and Launceston. Any change to pricing structure, even if it is in aggregate revenue neutral, must involve increases for some users and decreases for other users. The question is whether the new pricing structure gives better signals for the use of the assets, especially where capacity is constrained, as is the case at Sydney Airport. Passenger based charges generally result in a small lowering of overall price for wide-bodied aircraft and a small increase for narrowed-bodied aircraft. A system that encourages larger aircraft would appear to be efficient at a capacity constrained airport and resistance would likely to be driven by self-interest and not a genuine reason for regulation.

In the absence of some form of unlawful agreement between an airport operator and an airline, an airport's interest in addressing its pricing policy are closely, if not perfectly, aligned with maximising the productive and allocative efficiency of the very expensive fixed assets in question. Declaration for these reasons would seem only create the potential for addition compliance costs and regulatory failure.

**Definition of the relevant services and facilities**

The functional definition provided in Virgin Blue's application at point 3.1 (a) is the appropriate place to commence the consideration of the definition of service and facilities. It is appropriate to extend this definition to ensure coverage of other relevant markets such as international passengers and domestic and international freight. However, given the presence of readily available substitutes (such as Bankstown) and relative lack of national economic significance, it would not be appropriate to extend the service definition to general aviation.

The services that Virgin Blue has in mind clearly enable take off and landing and the movement of aircraft to and from terminal buildings, not the services provided by the terminals themselves. The services in question do not involve the embarkation or disembarkation of passengers or freight from the aircraft in question which is amplified by Virgin Blue's decision to withdraw its request to have terminal services declared and therefore terminals are not relevant facilities. Thus, the question of which passengers and freight can be loaded other than passenger terminals is not relevant.

We would see the facilities in question to be those to be broadly those described as "aircraft movement facilities and activities" in Direction No. 27 issued under the *Prices Surveillance Act 1983* on 26 June 2002. Adopting a definition of this type then
makes it clear that the provider of the operator of the relevant facility is SACL. To the best of our knowledge the leases mentioned by the Council relate only to aircraft parking areas immediately adjacent to Qantas’ domestic terminal and maintenance facilities and that these areas are not what Virgin Blue is seeking access to. Put another way, by adopting a pragmatic practical definition of services and facilities, the question of the declaration applying to facilities subject to protected contractual rights is avoided.

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.

In any event, our comments that follow are general in nature and should not in any meaningful way be affected by the fine detail of the definition of services and facilities ultimately adopted providing it broadly relates to the services contained largely or wholly within the airfield itself.

The "other" criteria

As indicated above, the Council's decision will really revolve around the questions of whether declaration would promote competition in another market and whether declaration would not be in the public interest.

In relation to the other criteria, is seems plain that the airside services provided by the nation's largest airport are of national significance. Indeed, we would argue that is also the case for Melbourne, Perth and Brisbane and probably Adelaide and Canberra.

We 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 ACCC can in no way obstruct aviation safety regulations which flow primarily from the Civil Aviation Act 1988.

In relation to whether it would be uneconomical for anyone to develop another facility to provide the service, a critical issue is the time frame in which such duplication may occur. It seems to us that the relative timeframe is that for which the declaration has effect. Our view would be that any declaration should not extend beyond the expected life of the current regulatory regime (which we believe to be 30 June 2007) but in any event, given previous declarations, it seems unlikely that the Council would recommend a period of longer than five years. Even if that period were ten years, given the current stance of government policy and the engineering and planning practicalities, it is impossible to conceive of a situation where another major airport (at this time nominate to be Badgerys Creek) could be operational within the life of the declaration. Clearly, similar constraints rule out Bankstown as a potential substitute. Thus, for all practical purposes, it is reasonable to conclude that

2 The Council's Issues Paper seems to imply Bankstown being an unsuitable substitute given its distance from the Sydney CBD. Bankstown is closer to the Sydney CBD than virtually every other site that has been considered as a second airport for Sydney. We'd also note Bankstown Airport is closer to the CBD of Sydney than Melbourne Airport is to the Melbourne CBD and in fact is closer to the population centre of Sydney than Sydney Airport is. The
developing another facility within the timeframe of the declaration is not only uneconomic but also infeasible.

Section 44G(2)(a)

Virgin Blue's argument in relation to this criterion seems to relate to the fact that the supply of the service is essential to the supply of domestic air transport services and that Sydney Airport is the only feasible supplier. As the Council notes, the existence of a dependant market is not sufficient to meet criterion (a).

To the best of our knowledge no suggestion has been made that Virgin Blue has or is likely to be denied access to the facilities it seeks to have declared. Indeed, assuming the Sydney Airport lease is the similar to those at Launceston and Melbourne Airport, except under extreme conditions that don't apply in this case, Sydney Airport would in all likelihood be in fundamental breach of its lease if it did deny Virgin Blue access to the facilities. Demand management legislation similarly constrains the capacity of Sydney Airport to deny access and it is Airport Co-ordination Australia, not Sydney Airport that determines slot allocations. Put simply, Sydney Airports capacity to deny access is severely limited and we believe it is arguable that taken together that these arrangements may constitute an effective access regime at least in the economic if not legal sense.

Even if it could deny Virgin Blue access, given Sydney Airport does not compete with Virgin Blue in any meaningful way, and given the fixed cost nature of airport businesses means that the profit margin on incremental revenue is very high providing capacity constraints are not reached, Sydney Airport has no commercial incentive to deny access. In particular, Sydney Airport has no incentive to act in a way that discourages entry into the dependant market. 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. Sydney Airport lacks both the capacity and incentive to deny access to airlines.

Since entry, Virgin Blue has been profitably operating a schedule using all its available aircraft and plans to introduce more over the coming months. Indeed, Virgin Blue has been so successful that it is now publicly canvassing listing on the Australian Stock Exchange this year. Virgin Blue does not suggest that the declaration sought in its application will lead it (or any other airline for that matter) to introduce further services to of from Sydney. We are not aware that access to the services (including issues related to price) in question has been raised by any potential new entrant as a barrier to entry. In short, Virgin Blue has produced no evidence that declaration will lead to further competition in any relevant market.

Section 44G(2)(f)

As indicated above, we believe declaration would not be in the public interest as it has the potential to undermine Government policy. Whilst the Government clearly contemplated airports continuing to be subject to Part IIIA, it seems to us that its intention, and certainly the view of the Productivity Commission, was that Part IIIA would be applied where there are intractable disputes. This is not the case here.

issue is cost and site constraints, not location and there may be very good reasons, such as noise, why a more distance location could be preferred.
The Council has noted the comments of the Treasurer in relation for time to need to be given for commercial arrangements to develop. They have in Melbourne and Brisbane and a range of other places. Whilst progress has been smoother in some than others have, robust commercial negotiations cannot be seen as an abuse of market power or a failure of policy. As noted above, 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.

We are also concerned that in the event that services were declared, the pricing principles set out in the Government's policy may not be applied by the ACCC. This concern arises out of our experience of the ACCC's administration of the price cap regime and in particular from its approach to the dual till issue when considering the Sydney Airport pricing proposal - conduct which ultimately forced Minister Hockey to issue a direction under the *Prices Surveillance Act 1983* to force the ACCC to comply with Government policy.

Whilst we understand the Council will consider material provided to it after the advertised closing date for submissions, we would ask you to treat this letter in its entirety as confidential until the close of business on 28 February 2003.

If you wish to discuss any of these matters, please feel free to call me on 9297 1368.

Yours sincerely

Dr Warren Mundy
MANAGER STRATEGY AND PLANNING