30 April 2003

Mr Graeme Samuel, AO
President
National Competition Council
GPO Box 250B
Melbourne VIC 3001

Attention: Ms Deborah Cope, Acting Executive Director

Dear Mr Samuel

Supplementary Submission in Relation to the Application by Virgin Blue for Declaration of Airside Services at Sydney Airport

Sydney Airport Corporation Limited (SACL) appreciates the opportunity to lodge a supplementary submission in relation to the application by Virgin Blue for declaration of certain Sydney Airport facilities, pursuant to Part IIIA of the Trade Practices Act 1974.

This supplementary submission provides further information sought by the National Competition Council in its letter of 2 April 2003. It also responds to a number of matters raised in the Virgin Blue submission of 7 March 2003 and the subsequent submission lodged on its behalf by Gilbert and Tobin on 7 April 2003.

Specific Requests for Information by the NCC

How are airport charges imposed and allocated for freight services?

Freight loaded and unloaded at Sydney Airport is either carried in the holds of passenger aircraft, or on dedicated freight aircraft. The majority of freight by tonnage is carried in the holds of passenger aircraft.

SACL does not levy any landing charges related to freight carried on board aircraft and there is no intention to impose a separate charge for belly freight as part of the contemplated move to passenger based domestic runway charges.

Freight carried on board passenger aircraft is generally loaded and unloaded by ground handlers engaged by airlines. Airlines can then choose to handle the freight through private cargo facilities on airport, or through the SACL common user ‘freight bypass’ facility. Airlines choosing to use the SACL bypass facility pay charges based on freight volume. Of course, airlines need not use any form of freight handling facility on airport, provided that they meet the appropriate airside management, security and customs requirements for the direct movement of freight on and off airport.
Dedicated freight aircraft are charged for use of runways and taxiways based on the scheduled "maximum take-off weight" (MTOW) of the aircraft. This will remain the case following the introduction of passenger based runway charges. As for belly freight on passenger services, freighter aircraft either use private freight handling facilities, or pay charges based on volume for use of the SACIL common user freight facility.

**Sydney Airport Slot Capacity Constraints**

Aircraft wishing to use Sydney Airport must do so in accordance with an allocated slot, determined in accordance with the *Sydney Airport Demand Management Act 1997* at the beginning of each scheduling season by an independent body called Airport Coordination Australia.

**Attachment A** is a chart showing the allocated slots for the current scheduling season, known as Northern Summer 2003. The allocation includes those slots that are subject to 'regional ring-fencing' for use by regional services. It also includes slots protected by the Minister for Transport and Regional Services from long-term reallocation after they were relinquished following the collapse of Ansett and decline in traffic related to SARS and the Iraq War. A second chart, at **Attachment B**, shows weekday average slot utilisation during March 2003.

**Capacity Constraints in relation to facility and slot availability**

Sydney Airport's primary capacity constraint is the restriction imposed by the *Sydney Airport Demand Management Act 1997* of 80 aircraft movements an hour.

Prior to 11 September 2001, Sydney Airport was generally capacity constrained in the morning peaks, between 0700 and 0900 hours. The events of 11 September 2001, collapse of Ansett, Bali bombing, Iraq war and Severe Acute Respiratory Syndrome have each temporarily alleviated some capacity pressures at the airport. However, SACIL currently anticipates that capacity constraints will again occur sometime between 2009 and 2014. Again, these are expected to be during the morning peaks, between 0700 and 0800 hours, and during the afternoon peak in between 1800 and 1900 hours.

As capacity constraints again start to emerge, SACIL will need to address them by encouraging increased average aircraft size and movement of traffic from the peaks to shoulder and off-peak times. While the best mechanism for doing this will need to be assessed more fully at the time, this would most likely involve some combination of operational measures and demand management pricing, with the latter potentially including increasing peak charges, reducing off-peak charges, and imposing minimum charges in peak periods. This would of course need to have regard to slots protected under the slot regime's 'regional ring fence' for use by regional services.

The introduction of demand management pricing to address capacity constraints and provide for additional aeronautical capacity was explicitly recognised in the Government's 13 December 2003 decision to deregulate airport pricing for a probationary period.

**Pass Through of Operating Cost Savings**

As an efficient organisation, SACIL manages its operating costs carefully and seeks cost efficiencies. Indeed, Sydney Airport's aeronautical charges approved by the ACCC explicitly provided for aeronautical operating cost savings of 4 percent per annum in real terms. That is, assuming constant traffic flows, SACIL 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.

Moreover, the airport has been significantly affected by the downturn in traffic following
11 September 2001 and subsequent events, which has inhibited SACL's ability to derive
revenue to earn a reasonable return on airport assets. As a result, SACL's current
aeronautical revenues are significantly below those allowed for by the ACCC as providing a
reasonable return, and are expected to remain that way for some time.

While increases in overall aeronautical charges could thus have been justified within a
regulatory framework, SACL has nevertheless not sought to recover the revenue shortfall
from airlines.

This approach to pricing is clearly not consistent with the actions of an organisation
misusing market power.

Security Charges from April 2003 to June 2003

Sydney Airport's security charges have increased from 1 April to 30 June 2003 to recover
the full year cost of additional war and terrorism insurance premiums for 2002-03.

War and terrorism insurance has gone from being provided as an extension to SACL's
base insurance policies without any specific charge prior to 11 September 2001, to
incurring premiums in 2002-03 of approximately $6 million. These premiums are twice
those of all SACL's other insurances, and have arisen as a direct result of the terrorism
attacks of 11 September 2001 and subsequent perceived threats of terrorism. Further,
SACL does not have discretion to vary the amount of cover that it holds so as to minimise
premiums, since the type and level of cover is mandated by Government as part of Sydney
Airport's lease and sale conditions.

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

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.

The costs are being recovered within SACL's existing 'additional security measure' charge.
This provides transparency as to the recovery and extends to terrorism insurance the same
reconciliation mechanism adopted with all security costs, where SACL adjusts charges in
subsequent years to ensure that it recovers only the actual costs incurred.

The additional charge between 1 April and 30 June 2003 has been set to recover the full
year's costs over the three month period. The time period over which the costs are to be
recovered was not SACL's preference, but was the result of lengthy consultation with
airlines on the temporary charge.
SACL has, however, passed on only its additional war and terrorism insurance costs. While the cost of other insurances held by SACL has risen by 81% since 2000-01, SACL has absorbed these increases as part of its operating cost base.

Recovery of reasonably incurred new expenses, where clearly outside of baseline costs, is not a demonstration of misuse of market power. We note 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.

**Rationale for a move from MTOW charges to Passenger-based**

From November 2001, with the approval of the ACCC, SACL converted its weight-based charges for international services to a single passenger-based charge. At the time, the ACCC judged that it did not have sufficient time within its statutory period to consider the concerns raised by Virgin Blue regarding the conversion of domestic weight-based charges to a passenger basis. The ACCC did not, however, indicate that the move to passenger based charges was not able to be justified.

Since the conversion to the international passenger services charge, a number of major Australian airports have adopted passenger-based charging. SACL considers that it is an appropriate time to move its domestic runway charges to a passenger services charge, to bring them into line with other major airports, and with Sydney Airport’s international charges and domestic terminal charges.

Airlines make decisions as to route frequency and aircraft size, and passenger-based charges remove the distortion between different sized aircraft. 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. They will 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.

The 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 considers that passenger-based charges will also enhance the airport’s accountability to airline passengers, allowing them to gauge the quality and value for money of airport services in relation to the more transparent airport charges.

Virgin Blue asserted in its comments to the ACCC in 2001 that passenger-based charges were inefficient because they were the opposite to Ramsey pricing, and impacted disproportionately on more price sensitive passengers.

However, Virgin Blue has not demonstrated that the proposed new form of charging will have any material effect on its ability to Ramsey price, by segmenting different elements of the air passenger transport market and set fares in accordance with the price sensitivity of different categories of traveller. As part of airlines’ existing approach to ‘yield
management', weight-based airport charges are effectively passed on to classes of passenger through airfares that vary with passengers' price sensitivity.

With the proposed introduction of passenger-based charges, average airfares should fall by the amount of weight-based airport charges that they currently include, and be offset by an airport passenger service charge that airlines may choose to separately identify on passenger tickets. However, the reduction in average costs resulting from the withdrawal of MTOW based charges can still be distributed by airlines across their various ticket prices taking into account the differentials they perceive in the price sensitivity of various types of passenger.

Response to Matters Raised by Virgin Blue in its Submission

Incentive to Use Market Power

SACL believes that, contrary to the assertions by Virgin Blue, the NCC has correctly stated that it is a necessary pre-condition to declaration that the access provider has not only the capacity but also the incentive to use market power.

Section 44G(2)(a) specifically provides that the Council cannot recommend that a service be declared unless it is satisfied that access or increased access would promote competition in a market other than the market for the service. Quite clearly, where there exists market power but no incentive to use it in a way that would deny or inhibit access, no promotion of competition can arise from declaration because the status quo will not change. The test is not one directed to the removal of the theoretical potential to use market power; rather, it is directed to the promotion of competition. Only where there is incentive to use market power in a way that would deny or inhibit access can the Council ever be satisfied that declaration would promote competition.

This in no way implies that declaration is only permissible where market power is exercised for the purpose or with the intention of reducing competition. Nor does it imply, as suggested by Virgin Blue, any inconsistency whatsoever with what was said by the Tribunal in Re Sydney Airport International Airport. In that case the Tribunal clearly accepted that the test in section 44G(2)(a) would be met only where the competitive environment would be changed as a result of declaration. Neither the Council nor the Tribunal can be satisfied as to this if there is no demonstrated incentive to use market power in a way that will adversely affect that environment.

Accordingly, SACL does not agree with Virgin Blue's criticism of the Council's Issues Paper and its claim that incentive to use market power is not a relevant consideration.

Further, we note that commercial considerations represent only one part of the incentive structure that inhibits use of market power by airports. The threat of re-regulation similarly provides a strong disincentive for airports to use market power in a way that affects competition between airlines.

The Government noted in its decision to deregulate airport charges for a probationary period that "The major airports have a strong commercial incentive to encourage passenger growth and maximise non-aeronautical revenue. Nevertheless, the Government will initiate a review if there is evidence of unjustifiable price increases." It went on to stress that "Ministers noted that the Government reserved the right to re impose price controls if it found that airport operators were abusing their market power by unjustifiably raising prices."
Virgin Blue's suggestion that SACL has demonstrated its incentive to misuse market power under deregulation and since privatisation does not withstand scrutiny. While other airports have used the opportunity to revise their aeronautical charges to provide a more commercial return on assets, SACL has retained its charges at a level that generates revenues well below those considered reasonable under a regulatory environment.

**Promotion of Competition**

As noted above, the introduction of a passenger services charge for domestic runway use is expected to promote competition in the market for domestic air services by removing the disincentive under MTOW charges to use larger aircraft, freeing up airport capacity for new entrants, and reducing the capital investment in airport facilities required to cater for a given level of passengers.

Virgin Blue has a misguided view of 'efficiency' in the use of airport infrastructure, assuming that it is measured by a comparison of aircraft weight and passenger capacity. Virgin Blue states in the supplementary submission lodged on its behalf by Gilbert and Tobin that it is a more efficient operator than Qantas because the aircraft it uses happen to weigh relatively less per passenger than the average fleet used by Qantas. It also suggests that domestic operators using small propeller aircraft are very efficient because of the light weight of their aeroplanes.

However, the proper measure of airport efficiency is maximising movement of passengers within a capacity constraint. Clearly, Virgin Blue and other operators of smaller aircraft are not efficient users of airport facilities. Such operators require more aircraft movements to carry the same number of passengers as larger aircraft. Indeed, by using airport landing slots, parking aprons and terminal gates in this way, operators of smaller aircraft limit the capacity available to cater for new entrant airlines. This relatively inefficient use of airport assets also increases the costs of using airport facilities, requiring a larger investment in airport capacity than would otherwise be required for a given level of passenger throughput.

This point also illustrates the incorrect assertion in the Virgin Blue 7 April supplementary submission that a passenger based runway charge "does not reflect the cost of providing the service". Virgin Blue is presumably suggesting that weight-based charges better reflect the wear and tear on runways imposed by particular sized aircraft. This cost, however, is relatively small compared with the opportunity cost of airport infrastructure used by small aircraft which potentially displace larger aircraft carrying more passengers per movement.

Virgin Blue has effectively assumed that the role of the access provisions of the *Trade Practices Act* is to preserve the status quo of a pricing structure, despite its inherent inefficiency, because of the transitional impact that some participants in a downstream market may experience as a result of a move to more efficient airport pricing. However, optimal competition in the downstream market will only be fully promoted when pricing in the upstream market (for airport facilities) is fully efficient. The change to passenger based runway charges will improve the efficiency of charging for airport facilities because it increases the contribution per passenger from smaller sized aircraft.

SACL considers that, while managing airport congestion is a complex matter that will require further action with time, the introduction of passenger based runway charges is an important step towards managing airport capacity utilisation. Moreover, because of the lead-time necessarily involved in changes to airline and aircraft scheduling, it is a step that needs to be taken well ahead of the time at which capacity constraints again emerge.
Derivation of the Proposed Passenger Services Charge

The Virgin Blue supplementary submission of 7 April 2003 sets out its assessment of the impact of the conversion of runway charges to a passenger basis. Virgin Blue suggests that "the proposed increase is in addition to the 97% increase in charges implemented by SACL less than two years ago".

Two points need to be made here. Firstly, the 97% increase to which Virgin Blue refers was approved by the ACCC as necessary and appropriate to allow SACL to generate a reasonable return on its aeronautical assets and reasonable operating costs.

Secondly, and more importantly, the proposed introduction of the passenger based charge is not intended to achieve an increase in overall SACL revenue, but simply to bring about a conversion from the current weight-based charges with reference to the set of passenger and tonnage forecasts that underpin existing aeronautical charges. While SACL agrees that the change may affect carriers differently for a transitional period, because of those carriers' fleet mix choices, it will place the airport's charges (and ultimately infrastructure usage) on a more economically efficient basis overall.

The derivation of the passenger based charge provided at Attachment C. This calculation is as per the ACCC in August 2001, save for the decision not to exempt transfer and transit passengers, and is a matter of public record. The charge is lower than that proposed to the ACCC because of the decision to also levy it on transfer and transit passengers. This recognises that such passengers use runway facilities and contribute to capacity constraints at the airport and should not be subsidised by passengers who commence or terminate their journey at Sydney Airport.

We note that Virgin Blue's estimates of the impact of passenger charges on Qantas and Virgin Blue, appended to its 7 April 2003 supplementary submission, are based on arbitrary assumptions as to passenger loads. However SACL's own estimates, based on actual passenger and tonnage data, show that while the passenger charge will increase overall amounts paid by Virgin Blue, it will reduce those paid by Qantas. This is because of the larger aircraft in Qantas' domestic fleet, noting that larger aircraft improve the efficiency of use of airport facilities.

Regardless of this transitional impact, as a matter of principle, SACL considers that passengers using the same Sydney Airport facilities should pay the same in airport charges regardless of which airline they fly with or the type aircraft on which they fly.

Efficient charges and market power

The Virgin Blue submission of 7 March puts forward the proposition that airports should be subject to price control because they would otherwise set charges above efficient levels.

The ACCC set aeronautical charges for Sydney Airport at a level that it considered would achieve a commercial return on SACL's airport assets, having regard to its operating costs and capital base. Notwithstanding that, it was arguable that the charges as set were below efficient levels because the ACCC valued aeronautical land based on an indexed historic cost of land, rather than a more appropriate opportunity cost measure.
Sydney Airport's charges are also below efficient levels because, in the current environment, they do not generate sufficient revenue to allow the airport to earn a reasonable return on assets, measured against the regulatory 'allowable revenue' assessed by the ACCC. Even following the conversion of domestic runway charges to a passenger basis, charges will remain well below efficient levels on this basis.

Despite this revenue shortfall, SAACL has not moved to increase its charges in a way that would have been justifiable under the former regulatory framework. Against this background, Virgin Blue's proposition is palpably without foundation.

Inconsistency with Public Policy

As SAACL identified in its 28 February 2003 submission to the NCC, declaration of airport services in the absence of any misuse of market power, or incentive to do so, would be contrary to the public interest in light of the Government's probationary deregulation of airport charges. Nothing in Virgin Blue's subsequent submissions provides cause to move away from that conclusion.

The Government determined that probationary price deregulation was appropriate to: allow airports greater flexibility to respond to the dynamic aviation environment and the needs of airlines and passengers; minimise regulatory administrative costs; and provide the correct incentives for airports to invest to cater for demand and maintain service quality.

SAACL accepts that access to Part IIA provides an important safeguard to misuse of market power, but it should be treated as such, a safeguard. Virgin Blue has not been able to demonstrate any unjustifiable pricing behaviour by SAACL, and accordingly to now declare airport assets under the Trade Practices Act would be inconsistent with the spirit of the Government’s decision and with the best interests of the public.

Yours sincerely

Max Moore-Wilton, AC
Chairman and Chief Executive
SYDNEY AIRPORT
Hourly Movements (Monday to Friday)
Sample Week April - October 2003

Movements

As at 30 April 2003
Full Allocation including Protected Slots (Ansett, NSW Regional, SARS/Araq)
Weekday Movements v Slots, March 2003

Source: Airport Coordination Australia and Air Services Australia
Derivation of Domestic PSC - ACCC Methodology

<table>
<thead>
<tr>
<th></th>
<th>2000/01</th>
<th>2001/02</th>
<th>2002/03</th>
<th>2003/04</th>
<th>2004/05</th>
<th>NPV</th>
</tr>
</thead>
<tbody>
<tr>
<td>WACC</td>
<td>8.86%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allowable Revenue - as determined by ACCC May 2001</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Runway Charge</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M10W per Arrival and departure</td>
<td>$3.44</td>
<td>$3.44</td>
<td>$3.44</td>
<td>$3.44</td>
<td>$3.43</td>
<td>$3.43</td>
</tr>
<tr>
<td>Forecast Landed Tonnes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic Passenger Aircraft</td>
<td>6,357,000</td>
<td>6,720,000</td>
<td>6,704,000</td>
<td>7,000,000</td>
<td>7,384,000</td>
<td>28,983,002</td>
</tr>
<tr>
<td>Forecast Domestic Passengers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Passengers, excl Regional</td>
<td>15,153,000</td>
<td>16,127,000</td>
<td>16,382,000</td>
<td>16,969,000</td>
<td>17,733,000</td>
<td>69,575,544</td>
</tr>
<tr>
<td>Estimated Transfer and Transits</td>
<td>14.4%</td>
<td>-2,184,811</td>
<td>-2,325,245</td>
<td>-2,363,454</td>
<td>-2,446,648</td>
<td>-2,556,804</td>
</tr>
<tr>
<td>Net Passengers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic PSC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excluding Transfer/Transit Passengers</td>
<td>$3.35</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Charged on All Domestic Passengers</td>
<td>$2.96</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Summary of exclusion

<table>
<thead>
<tr>
<th>Connecting to another aircraft:</th>
<th>Inbound</th>
<th>Outbound</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfers - International (net of infants and positioning crew)</td>
<td>7.51%</td>
<td>7.01%</td>
</tr>
<tr>
<td>Transit same flight number (net of infants and positioning crew)</td>
<td>4.48%</td>
<td>4.56%</td>
</tr>
<tr>
<td>Total Positioning Crew</td>
<td>0.72%</td>
<td>0.79%</td>
</tr>
<tr>
<td>Total Infants</td>
<td>1.89%</td>
<td>1.92%</td>
</tr>
<tr>
<td>Average</td>
<td>14.42%</td>
<td>14.24%</td>
</tr>
</tbody>
</table>