APPLICATION RE DECLARATION OF AIRSIDE SERVICE AT SYDNEY AIRPORT

RESPONSE TO NATIONAL COMPETITION COUNCIL QUESTIONS

This document sets out the response of Virgin Blue Airlines Pty Limited (Virgin Blue) to the questions asked by the National Competition Council (Council) in a letter dated 2 April 2003.

1. To what extent are your freight operations distinct to and/or integrated with your domestic passenger services in an operational sense? Is there any internal charging/cost allocation for aircraft space between passenger and freight departments/entities? If so, on what basis is this charge calculated?

1.1 The freight services offered through Virgin Blue are not integrated with its passenger services, except to the extent that passengers and freight are carried on the same flights.

1.2 Virgin Blue itself does not provide freight services directly to consumers. Instead, Virgin Blue has an agreement with a third party which operates as Virgin Blue Freight Management (VBFM) under which VBFM supplies a wholesale freight carriage service to freight companies who in turn supply freight services to consumers. As a general rule, VBFM does not provide pick-up from customers’ premises or delivery to final destinations.

1.3 Under the terms of the agreement between Virgin Blue and VBFM, VBFM is responsible for the marketing and selling of freight services to freight companies as well as ensuring that freight is delivered to the freight shed at the airport for loading on scheduled Virgin Blue services. Virgin Blue is responsible for loading the freight on to the aircraft and the delivery of the freight to the intended airport at which point the freight is passed back to VBFM and then on to the other freight companies for delivery to its intended destination or collection.

1.4 In return for the services provided by Virgin Blue, it receives a share of the revenue earned by VBFM through the provision of the wholesale freight carriage service.

1.5 Most of the costs that Virgin Blue incurs in the supply of its freight services are common to the costs it incurs in the supply of its passenger services, although there are some other relatively minor costs associated with these services which are not common to passenger
services. Virgin Blue does not allocate or internally charge any of these common costs or other minor costs to any Virgin Blue freight service entity.

2. How are airport charges (including charges for Airside Services) allocated to freight services?

2.1 As discussed above, Virgin Blue does not allocate any costs to freight services. This extends to airport charges.

3. To what extent are operational decisions such as scheduling determined by freight as opposed to domestic passenger requirements? Would it be fair to say that most operational decisions are based on passengers requirements with freight a secondary consideration?

3.1 Virgin Blue’s operational decisions such as flight scheduling are based almost entirely on passenger requirements, and freight is very much a secondary consideration.

4. What proportion of your airline’s total domestic services revenue/profit is attributable to freight and what proportion to passenger services?

4.1 Revenue received from freight services account for only approximately [c-i-c] of Virgin Blue’s total annual revenue. The remaining amount is attributable to Virgin Blue’s passenger services.

4.2 Virgin Blue cannot accurately measure the contribution freight services makes to its profits as it does not separately allocate any costs to those services.

5. Would it be commercially rational to operate a passenger only service without offering freight transport services? Are there any domestic operators that do so?

5.1 In deciding whether or not to offer freight services, an airline already offering domestic passenger services would need to consider the following factors:

(i) its aircraft would be designed to carry their passengers’ luggage with space left over in the hold for air freight;

(ii) the incremental cost of supplying air freight services is low; and

(iii) it is a relatively simple administrative process for an airline to provide air freight services, particularly using the model adopted by Virgin Blue where all of the
marketing, sales and other front of house functions are undertaken by a third party.

5.2 Therefore, Virgin Blue considers that if an airline chose not to provide air freight services it would be choosing to forgo a revenue stream that is relatively easy and inexpensive to exploit. On this basis, Virgin Blue considers that it would be unusual for an airline operator not to offer air freight services of some kind.

6. How easy/difficult is it to reconfigure aircraft for more/less cargo/passenger space? Is reconfiguration only practical at the time of an aircraft's original fitout or refit? What factors would an airline take into account in deciding to reconfigure an aircraft?

6.1 Unless 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.

6.2 Some aircraft are designed to be used interchangeably as either a dedicated freight or a passenger aircraft. The Boeing 737 QC ("quick change") is an example of such an aircraft. These models allow for the easy and quick removal of seats from an aircraft to transform it into a dedicated freight aircraft. They are not, however, very common. Virgin Blue estimates that there are less than 50 Boeing 737 QCs in operation today, and there are none operating in Australia.

6.3 Virgin Blue is not considering reconfiguring its aircraft to make them dedicated freight aircraft.

7. What proportion of domestic air freight is carried by scheduled passenger aircraft?

7.1 Virgin Blue does not have this information.

7.2 The Bureau of Transport and Regional Economics (BTRE) and the Department of Transport and Regional Services (DOTARS) are likely to have some useful information in this regard. Virgin Blue notes that NECG in its paper Report on the Competitive Effects and Public Benefits Arising from the Proposed Alliance between Qantas and Air New Zealand dated 8 December 2003¹ was able to determine this amount for international and trans Tasman freight services using data provided by DOTARS.

¹ This NECG paper was provided in support of the application for authorisation made by Qantas Airways Limited and Air New Zealand Limited on 9 December 2002. It is available at the website of the Australian Competition and Consumer Commission at http://www.accc.gov.au/adjudication/fs-adjudge.htm.
8. What factors are taken into account in determining specific aircraft scheduling and timetabling for different seasons?

8.1 The principal determinant of Virgin Blue’s scheduling is profitability.

8.2 Virgin Blue schedules its flights on a route at those times which it considers will maximise its profitability taking into account a large number of factors including expected peaks and troughs in demand (either daily, as a result of special events or changes in seasons), the length of the route, the costs of operating on that route, airport curfews, aircraft availability, slot availability and crew availability.

8.3 In making the decision to schedule a service, Virgin Blue will look at the expected returns from that service given expected costs and demand for that service. It will also, however, look at other opportunities it might be forgoing by offering that service, that is, the opportunity cost of providing that service.

9. How often are schedules (i.e. routes, timetables and the allocation of specific aircraft types to provide a service) altered once a season is set? What are the main reasons for such alternations? For example, what price/yield increase would be needed on a particular route before a decision to add/remove services or change aircraft type on that route would be made?

9.1 For the purpose of forward sales, Virgin Blue offers a preliminary schedule extending forward up to 12 months. For a particular month, the schedule is then finalised in the preceding month and that final schedule is then used for the purpose of rostering. Once a schedule has been finalised, it would be unusual for that schedule to be altered because of the requirement for aircraft crew and ground crew to have a level of certainty in relation to rostering.

9.2 Due to the rate of growth since it commenced operations, Virgin Blue has had little cause to significantly alter its schedule other than to add flights. Virgin Blue anticipates considerable additional growth, and accordingly, that most alterations to its schedules will be the addition of new services.

9.3 However, where there are expected peaks and troughs in demand, Virgin Blue will alter its schedule in anticipation of those peaks or troughs. For example, if during the Grand Prix demand for services to Melbourne could not be met by scheduling one of Virgin Blue’s larger 737 – 800 to fly that service, then Virgin Blue will add additional services.

9.4 While the principal determinant of scheduling is profitability, the schedule is not determined on this basis alone. There are a number of other factors that may affect
Virgin Blue’s decision whether to add or remove services, such as the expected medium and long term trends for that service. For example, if for unexpected seasonal reasons a service was not profitable in a particular month, Virgin Blue would not automatically cease to provide this service if there were good future prospects for that service. If Virgin Blue continually changed its schedule by adding and removing flights in accordance with monthly profitability figures then the travelling public would no longer have certainty from month to month in relation to particular Virgin Blue flights or routes.

10. To what extent are aircraft currently redeployed between different domestic routes as demand conditions vary? What (if any) are the impediments to such redeployment? Can all types of aircraft be readily redeployed between different domestic routes? If not, please explain why.

10.1 For the reasons stated in paragraph 9.2, there are few examples of Virgin Blue redeploying aircraft throughout its network. If growth were to stabilise, then Virgin Blue may have to consider the redeployment of aircraft throughout its network.

10.2 See also Virgin Blue’s response to question 11 below.

11. To what extent are aircraft currently redeployed between regional (ie. intrastate), domestic, trans-Tasman and other international routes? What (if any) are the impediments to such redeployment? Can all types of aircraft be so readily redeployed? If not, please explain why.

11.1 Virgin Blue operates one broad type of aircraft, namely the Boeing 737. However, the routes that can be flown by a 737 is limited by the specifications to which that particular 737 is configured as well as the flight distances for which that 737 is certified (by the engine and aircraft manufacturers).

11.2 A high gross weight 737 is one that has been configured and certified to fly long haul flights (up to 6 hours). A low gross weight 737 is one that has been certified and configured to operate on short haul flights (less than 3 hours). The cost of configuring and certifying a high gross weight 737 is approximately $4 million more than the cost of certifying and configuring a low gross weight 737.

11.3 Virgin Blue requires a certain number of high gross weight 737s to operate on its long haul services, for example, all of its services to Perth and its services from Melbourne to far north destinations such as Cairns. However, Virgin Blue offers many short haul services for which a low gross weight 737 is sufficient. For this reason, Virgin Blue’s fleet is divided into low gross weight and high gross weight 737s.
11.4 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.

11.5 Virgin Blue does not currently offer trans-Tasman or other international services.

12. To what extent is the operation of a national domestic network necessary for a carrier's commercial viability?

12.1 The importance of a national domestic network depends entirely on the airline's business model. It is possible to operate an airline that does not have a national network. For example, Regional Express does not operate a national network, and when Virgin Blue first commenced operations it only offered limited services into and out of Brisbane.

12.2 However, if an airline has a business plan which depends upon being a national carrier with a national network (as Virgin Blue does now), then 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.

12.3 Virgin Blue does not consider that it would be commercially feasible to be a national carrier without operating into and out of Sydney Airport.

13. To what extent is wet leasing (or other arrangements) used to add services on routes as opposed to diverting aircraft otherwise used on other routes? How quickly and easily can aircraft be wet leased?

13.1 Virgin Blue does not currently operate any wet leased aircraft but it has done so previously on an ad-hoc and short term basis on a small number of occasions.

14. To what extent can foreign carriers provide Australian domestic services? Is it the case that only Australian and New Zealand majority owned carriers can operate Australian domestic services?

14.1 A carrier owned by a foreign person can provide domestic air passenger services within Australia. Provided that the requirements of the Foreign Acquisition and Takeovers Act 1975 and other local regulatory requirements have been met (for example obtaining an air operators certificate (AOC) to operate domestic services within Australia), a foreign
person has the same ability as an Australian person to provide domestic air passenger services in Australia. For example, when Virgin Blue commenced operations in Australia, it was a subsidiary of a foreign person.

14.2 Therefore, it is not the case that only Australian and New Zealand majority owned carriers can operate Australian domestic services.

14.3 A foreign owned carrier that is not licensed under the Australian regulatory system to provide domestic air passenger services in Australia does not have the right to provide such services unless it is granted that right by way of a bi-lateral agreement between Australia and the country of origin of the carrier. This right is referred to as the “ninth freedom” or cabotage.

14.4 Australia and New Zealand are parties to an Open Sky agreement, which reduces the regulatory barriers for carriers of one nation to commence operations in the other country. For example, Australian carriers are granted the right of cabotage within New Zealand. Therefore, there is no requirement for an Australian carrier to obtain a New Zealand AOC and comply with other domestic licensing requirements before it commences domestic operations. Virgin Blue understands that New Zealand is the only country in respect of which Australia has granted cabotage rights.

15. How important is airline branding at gates and passenger processing facilities?

15.1 Brand loyalty is very important in the airline industry. Airlines spend vast amounts of money developing their brand and brand recognition. Apart from the obvious answer that the branding of gates and other facilities assists customers to identify the correct gate from which their service will depart, any opportunity by an airline to brand its service is of significant value.

16. Please detail general market share and price trends for domestic routes as a whole over the past year.

16.1 The BTRE has useful information regarding price trends in domestic air fares, which it measures on a quarterly basis. This can be found at http://www.btre.gov.au/docs/indicate/airfares.htm#Top. A graphical representation of this data is set out in figure 1.
16.2 DOTARS provides Virgin Blue with information concerning its share of passengers on certain routes. It does not provide Virgin Blue with information on the market share of its competitors (principally Qantas). However, we assume DOTARS would make all of this information available to the Council.

16.3 Table 1 sets out Virgin Blue’s share of the total domestic revenue passengers in the year from January 2002. These amounts were calculated by DOTARS using passenger numbers from all domestic routes including those on which Virgin Blue does not fly.

**TABLE 1**

| [c-i-c] |

16.4 Table 2 sets out Virgin Blue’s share of the total domestic revenue passengers taking into account only those routes on which it operates in the year from January 2002. These amounts were calculated by DOTARS only taking into account passenger numbers on those routes on which Virgin Blue flies.

**TABLE 2**

| [c-i-c] |
17. Please detail the extent (if any) to which capacity has been expanded and new routes added to your domestic network over the past year.

17.1 In April 2002 Virgin Blue offered services on 17 routes with 15 aircraft. In April 2003, Virgin Blue offered services on 30 routes with 29 aircraft and expects to commence operations on another 3 routes shortly.

17.2 If the Council would find details of Virgin Blue’s capacity growth on particular routes useful, then Virgin Blue is able to provide this information on request. Virgin Blue’s website (www.virginblue.com.au) contains substantial additional information on Virgin Blue’s growth and the routes that it operates on.

18. To what extent is the position of Qantas as a dominant domestic carrier a barrier to entry for new carriers or expansion of existing carriers?

18.1 Virgin Blue considers that the strategic response of incumbent airlines can be a significant barrier to successful and substantial entry or expansion for any new entrant airline. It is well recognised in economic and competition law literature that a typical strategic response of an incumbent airline to new entry is to engage in targeted expansion of capacity in order to reduce the yields and load factors of the new entrant and thereby undermine its financial viability.

18.2 This is consistent with the findings of both the Australian Competition and Consumer Commission (Commission) and New Zealand Commerce Commission (Commerce Commission) which, in their respective draft determinations on the applications of Qantas and Air New Zealand for authorisation of certain cooperative arrangements between the parties dated 10 April 2003 (Draft Determinations), found that the strategic conduct of an incumbent represents a significant barrier to entry.

19. How important is the operation of services at peak times into and out of Sydney Airport to a new entrant airline or an airline looking to expand services to/from Sydney?

19.1 While there are opportunities to offer services outside periods of peak demand, these opportunities are obviously limited. This is because off-peak periods are not (by definition) the periods in which most people want to fly.

19.2 Therefore it is obviously extremely important for Virgin Blue to offer services during periods of peak demand. This is particularly the case with business customers who tend to have more pronounced and more fixed peaks in demand compared to other customers.
20. How important is access to facilities (including terminals) other than those specifically required to provide the Airside Services to airlines wishing to expand or start up new services to and from Sydney Airport? How difficult is it to get access to these facilities? Are any of these facilities currently or likely to be capacity constrained?

20.1 Airlines wishing to start up new services to or from Sydney Airport will require access to terminal and other facilities at Sydney Airport not used to provide the Airside Service. A passenger and freight transport service cannot be provided at Sydney Airport if there is no way to allow passengers to board and disembark the aircraft and freight to be loaded and unloaded. Passenger and freight transport services to and from Sydney Airport cannot be expanded if there is insufficient terminal and other facilities to process the additional passengers and freight.

20.2 At Sydney Airport, access to terminals and other facilities can only be obtained from Sydney Airports Corporation Limited (SACL) which is the monopoly provider. Virgin Blue understands that there is currently excess domestic terminal capacity at Sydney Airport in both Terminal 2 and the Domestic Express Terminal, however access to this capacity and the provision of any additional capacity (if necessary in the future) is subject to commercial negotiations between the access seeker and the monopoly provider, SACL.

20.3 Virgin Blue has obtained access to domestic terminal facilities on commercially acceptable terms, but notes that these negotiations were protracted and difficult.

21. DOTARS suggests that Sydney Airport may be slot capacity constrained at some time from 2006/7 to 2010/11. Does this accord with your expectations? How does this expectation affect your future operating plans?

21.1 Virgin Blue understands that Sydney Airport is not currently slot capacity constrained. However, Virgin Blue considers that it is very difficult to come to any firm conclusion about slot availability during a period from 3 to 8 years in the future because it is not possible to predict with any accuracy what the state of the airline industry will be at that time given the vast range of possible events and other variables that need to be taken into account.

22. What proportion of total domestic air freight goes into, out of or transits through Sydney Airport?

22.1 Virgin Blue does not have this information but notes that the BTRE or DOTARS may be able to assist in this regard.
23. **What proportion of air freight charges passing through Sydney Airport is made up of Sydney Airport aeronautical charges?**

23.1 Virgin Blue currently does not pay a separate aeronautical charge for the freight it carries in the hold of its aircraft on scheduled passenger flights. Charges for the use of Airside Service at Sydney Airport are currently principally levied according to the maximum take off weight (MTOW) of an aircraft, which is specified by the manufacturer of an aircraft and is not dependant upon the amount of passengers or freight the aircraft is carrying at a particular time.

23.2 However, as the Council is aware, SACL is proposing to move from charging on an MTOW basis to a per passenger basis. Virgin Blue considers that this move would encourage inefficient use of the airport facilities and detrimentally affect competition by placing Virgin Blue at a significant competitive disadvantage. Virgin Blue refers to its letter to the Council dated 1 April 2003 in this regard. Virgin Blue is not aware of how (or if) SACL proposes to incorporate the amount of freight carried by an aircraft into the proposed new charges for the Airside Service.

24. **Please provide details as to the nature of the domestic air freight market. In particular:**

- Identify significant competitors and estimate market shares
- General price trends over the past year
- Detail the relationship between your freight operation and freight forwarders generally.

24.1 For the reasons set out in its submission dated 7 March 2003 in response to the Council’s Issues Paper, Virgin Blue does not consider that there is a domestic air freight market as such, rather, due principally to complementarities in supply, the product dimension of the relevant market should include both freight and passengers.

24.2 As noted in its responses to questions above, Virgin Blue’s participation in the freight industry is limited, and Virgin Blue considers freight services to be of secondary importance to its passenger services. Accordingly, Virgin Blue has limited information which will assist the Council in response to this question.

24.3 However, Virgin Blue understands that the majority of dedicated domestic freight services are provided by Australian Air Express, a joint venture between Qantas and Australia Post and that the freight forwarding business is dominated by Qantas Freight.
24.4 VBFM works closely with freight forwarders.

25. What are the barriers to entry and expansion in the domestic air freight market

25.1 As noted above, Virgin Blue does not consider that there is a separate market for the supply of domestic air freight.

25.2 Accordingly, the barriers to entry faced by a person who wishes to supply freight services are the same as those faced by a person wishing to supply passenger services. The more significant of these are:

(i) strategic barriers to entry;

(ii) access to facilities. For a dedicated freight service this may require freight storage facilities on the tarmac fringes; and

(iii) capital requirements.

25.3 Virgin Blue notes that the issues of barriers to entry into various airline markets was discussed in detail by the Commission and the Commerce Commission in the Draft Determinations. Virgin Blue believes that many of the issues discussed by the Commission and the Commerce Commission are relevant to the current considerations of the Council.