Sydney Airport Corporation Limited

Submission in Response to the

National Competition Council Draft Recommendation

on the

Virgin Blue Application for

Declaration of Airside Services at Sydney Airport

August 2003
1.0 Introduction

In SACI's view, the information presented to the National Competition Council (NCC) does not warrant declaration of airside facilities. This is because:

1. Declaration cannot reasonably be expected to have any material effect on competition in the market for domestic passenger services. The evidence before the Council does not adequately consider the interaction between airport charges and overall competition in the market, and the preliminary analysis does not differentiate between differing levels of consumption, and effects on competition.

2. The draft assessment, and the information presented to the Council, take a simplistic view of the incentives acting on Sydney Airport under light-handed regulation. The range of countervailing factors influencing pricing behaviour can and do curtail any incentive to monopoly price. This can be seen from the behaviour of not only Sydney Airport, but of other airports operating under light-handed regulation which have been given the opportunity to reach agreement with airlines on pricing, without the need for any regulatory intervention.

3. The potential benefits of declaration can be demonstrated to be significantly lower than expected costs. On this basis, the public interest test for declaration cannot be satisfied.

Accordingly, neither the promotion of competition, nor the public interest criterion has been satisfied in relation to the Virgin Blue application.

We are also concerned that the NCC has adopted an initial position which is difficult to reconcile with the Government's policy on light handed regulation, and does not provide a coherent statement of the role of Part IIIA within the overall policy framework.

This interpretation has significant implications for the perception of regulatory risk, not only in the airports sector, but for infrastructure providers generally.

Virgin Blue's application for declaration of Sydney Airport facilities is not about seeking improved access with the aim of promoting competition in the market for domestic passenger services. Virgin Blue is seeking to maintain an unintended commercial advantage vis a vis its competitors.

This submission considers Sydney Airport's three main concerns, listed above, with the Council's draft recommendation. SACI has been assisted in preparing this document by economic advisers, n/a/ta, and legal advisers, Mallesons Stephen Jaques. Reports from these organisations are appended to this submission.

2.0 Promotion of Competition

In its draft recommendation, the NCC states that declaration would promote competition in the market for domestic passenger air services in Australia, as it would curtail the potential for SACI to use its market power. In SACI's opinion, the NCC's analysis has incorrectly assessed, and consequently has significantly overstated, the potential for declaration to promote competition.

2.1 Legal Interpretation of the Criteria

The attached advice from Mallesons Stephen Jaques raises significant concerns with the manner in which the Council has interpreted and applied criteria 44G(2)(a) with regard to the Virgin Blue application. In particular, Mallesons advise that in the Council's construction and application of criterion (a), it has not:
applied the appropriate concept of 'competition';

• allowed criterion (a) to have any meaningful operation;

• properly assessed the materiality of any impact on the promotion of competition; and

• despite its claims to the contrary, confined its consideration to the promotion of competition, rather than the promotion of individual competitors in the market.

These matters are expanded on below, and discussed in more detail in the attached report prepared for SA CL by Mallesons Stephen Jaques.

2.2 Competition, Not Consumption

The primary function of the Part IIIA access regime is the promotion of competition.

The NCC has taken the initial view that, if declaration were to lead to lower prices for aeronautical services, then this would lead to an increase in competition. However, it would be more accurate to describe this as an increase in consumption, not an increase in competition.

Changes in the level of aeronautical charges will not necessarily have any effect on the level of competition in the market place. To the extent that a change in the price for aeronautical services influences airfares in the downstream market, passengers may consume more or less of the domestic airline service. However, this is not itself a sign that the process of competition has been adversely affected, that is, the number of airlines competing or their ability to compete in the market.

2.3 True Promotion of Competition

Precedent cases have justifiably found that true promotion of competition is about reducing barriers to entry and enhancing the ability for new market entrants.

The Australian Competition Tribunal found, in the QCMA case, that "competition is a process rather than a situation" and that "of all these elements of market structure, no doubt the most important is...the condition of entry". This is consistent with the Tribunal's Duke Decision, which recognised that "criterion (a) is concerned with the removal of barriers to entry which inhibit the opportunity for competition in the relevant downstream market". The Sydney Airport Decision also noted that the role of Part IIIA is to "unlock a bottleneck so that competition can be promoted."

In SA CL's view, the evidence presented to the Council has not established that declaration would reduce barriers to entry or promote the process of competition.

Apart from issues with the Council's initial interpretation of competition, SA CL notes the view of the Tribunal in the Duke Decision, that there should be a "likelihood of increased competition that is not trivial." SA CL does not consider that the NCC's analysis supports a view that the potential for increased competition in the downstream market is material in nature.

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1 Re Queensland Cooperative Milling Associated Limited, 1996, ATPR 40-012 at page 17, 246.
3 Sydney International Airport [2000], ACompT 1 Re Review of Freight Handling Facilities, Paragraph 107.
2.3.1 SACL’s Incentive is Pro-Competitive

The Council states that in “the absence of any constraints on SACL’s ability or incentive, the Council must conclude that SACL has the requisite power to satisfy criterion (a) [promotion of competition]” [emphasis added]. Mallesons’ significant concerns with this approach are set out in the attached paper. As we have already noted, criterion (a) is not satisfied merely by possession of market power, but by an expectation that declaration would promote competition in a downstream market.

In terms of promotion of competition, it is not the level of charges that is relevant, but whether an airport discriminates between incumbent airlines. The NCC recognised that SACL may not have the ability and incentive to adversely affect competition in the domestic passenger market where the airport’s optimal strategy was to promote competition in that market6.

SACL is not vertically integrated with any airline, nor does it have any commercial arrangements with an airline that provide it with the incentive to favour one over another through the imposition of aeronautical charges. The Council noted that it was not aware of any arrangement with an airline that would cause SACL to leverage its market power to advantage that entity and itself7.

In fact, the superior financial outcome for SACL will be achieved through promoting passenger throughput at the airport. This in turn is achieved through promoting airline competition, which leads to lower airfares and expanded airline seat capacity.

SACL’s incentive not to discriminate between airlines has been demonstrated by the airport’s implementation of a common runway use charge for all domestic passengers. In doing so, SACL resisted the calls from Virgin Blue to provide it with concessions intended to maintain an unintended commercial advantage that Virgin Blue received under tonnage based charges.

2.3.2 Removal of Barriers to Entry at Sydney Airport

The reason that Virgin Blue seeks to have Sydney Airport facilities declared is in an attempt to overturn the move to passenger-based runway charges. Declaration itself would not have any genuine effect on competition, yet the move to passenger-based charges that Virgin Blue opposes represents the true removal of a barrier to entry. A significant hurdle to the successful commencement of operations by a new airline is covering fixed costs with initially low passenger loads. The move from tonnage based charges converts airport fees to a variable cost and allows start-up airlines to share their passenger load risk with airports.

Of course, Virgin Blue would have us believe that it remains a new entrant airline. It is, however, a market incumbent, and as such its incentive is to resist any arrangement that may encourage additional competition in the domestic market from genuine new entrants. This was the same incentive behind Virgin Blue launching its access application in the first place - to try and implement an alleged arrangement that would have given it long-term, dedicated use of half of the former Ansett terminal, to the exclusion of new entrants.

2.3.3 Declaration Would Hamper Commercial Outcomes

Declaration of the Airside Service would not promote competition in the domestic passenger air services market. It would, however, materially alter the way in which negotiations take place, increase the costs of those negotiations. The prospect of concluding commercial negotiations on terms satisfactory to both parties would be dramatically reduced by the ever-present threat of the ACCC being called in to arbitrate on key terms and arrangements. In a

5 Application by Virgin Blue for Declaration of Airside Services at Sydney Airport, Draft Recommendation, National Competition Council, June 2003, Paragraph 6.113
6 Ibid, paragraph 6.108.
7 Ibid, paragraph 6.116.
declared environment, unless the terms offered by Sydney Airport were especially favourable, airlines would have little to lose from attempting to secure a better arrangement through arbitration.

2.4 Aviation Market Considerations

In forming a view about the potential for declaration to promote competition in the market for domestic air services, SACL has a number of concerns about the assumptions made and preliminary conclusions derived by the Council. These issues are discussed further in the attached report from n/e/t/a.

2.4.1 Structure of the Aviation Market

The 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, noting the NCC’s view that an assessment of the application against the competition criteria “is concerned with an assessment of the structure of the dependent market”.

2.4.2 Airport charges as a proportion of airfares

The NCC noted the Productivity Commission’s finding that airport charges comprise 2% - 3% of average airfares. Virgin Blue asserted that runway charges can amount to “up to 10% of Virgin Blue’s commonly offered ticket prices”. With the domestic PSC at Sydney set at $2.88, this would imply an airfare of only $29 one-way. It is clearly misleading to imply that such a fare is ‘commonly offered’, with a recent sample of lowest available fares to Melbourne and Brisbane on one-month advance purchase being $65 mid-week, an $84 ‘Fair Fare’, ranging up to $194. This suggests that Sydney Airport runway charges range between 1.5% and 4.4% of available Virgin Blue fares.

2.4.3 Price elasticity

The average price elasticity of passengers to airport charges is relatively low. The NCC cited Frontier Economics (on behalf of Virgin Blue) information that a 100% increase in airport charges would reduce passenger traffic by between 2% and 5%. While SACL contends that an assessment of price sensitivity based on market segments is more appropriate, these estimates of average elasticity reinforce that changes in airport charges have a diminutive effect on propensity to travel.

2.4.4 Price discrimination

In practice, airlines are highly sophisticated price discriminators and will pass on increases in airport charges to the least price sensitive passengers. Virgin Blue itself indicated that increases in airport charges would be either passed on through increased fares, absorbed by the carrier, or a combination of the two. Even where charges are passed on to passengers, the effect on passenger tickets is very different from the dollar-for-dollar relationship assumed by the NCC. The practical consequences of price discrimination are discussed further in the n/e/t/a report, and under the costs and benefits section below.

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9 Submission in Response to the National Competition Council's Issues Paper, Virgin Blue, 7 March 2003, page 16.
10 Application by Virgin Blue for Declaration of Airside Services at Sydney Airport, Draft Recommendation, National Competition Council, June 2003, paragraph 6.114.
11 Submission in Response to the National Competition Council's Issues Paper, Virgin Blue, 7 March 2003, page 16.
2.4.5 Virgin Blue is a market incumbent

Both n/e/l/a and Mallesons point out that the Council has distorted its analysis by focusing unduly on the position of one particular participant in the market for domestic air services - Virgin Blue. The Dawson Committee Review of the Trade Practices Act recently confirmed that the purpose of the Act is to "protect and advance a competitive environment and the competitive process rather than to protect individual competitors". The domestic aviation market has two incumbent carriers, and a balanced analysis of the potential effects of competition in that market requires an assessment of the position of both airlines, and the barriers to entry to new carriers.

The Council has been provided with evidence of the alleged vulnerability of Virgin Blue in the Australian domestic aviation market. Virgin Blue has attempted to perpetuate the myth that it remains a new entrant airline. In fact, with a 27.7% overall market share and 30% share of the key Sydney, Melbourne and Brisbane routes, clearly, Virgin Blue represents a market incumbent.

It is also profitable, growing and well financed (see below). The key issue in terms of promoting the process of competition is not preserving Virgin Blue, but in removing barriers to entry and encouraging further new entrants. These may well be full fare carriers and are very likely to have low load factors, at least initially. As such they are likely to be best assisted by quite different policies than those supported by Virgin Blue. In practice, in countries where traffic charges have been directly negotiated with airlines, carriers with start up services (whether low cost or other) almost universally favour per passenger charges, because they reduce their costs when load factors are low and thus lower their risks.

2.4.6 Characteristics of Low-Cost Carriers

The NCC’s initial view is that low-cost carriers such as Virgin Blue may be less able to absorb increases in airport charges than full service carriers, and hence would be more likely to be harmed competitively. However, while Virgin Blue may be a low cost airline, it is not necessarily a low margin airline compared with Qantas.

Its very low cost structure, with costs some 20% lower than Qantas\textsuperscript{13}, leaves it better placed to absorb airport charge increases and remain competitive. This is evidenced by Virgin Blue’s estimated earnings per plane, which is among the highest in the world at $US5.3m, almost a million dollars per plane higher than Qantas at $US4.4m per plane. It is also among the world’s most profitable airlines, announcing a profit before tax of $158m for the year to 31 March 2003\textsuperscript{14}.

Virgin Blue Chief Executive, Mr Brett Godfrey summed up the airline’s competitive position in his 2003 profit announcement, stating that “while our local competition is Qantas, we benchmark ourselves globally against the leading low-cost carriers as they have demonstrated their growing dominance in the short-haul aviation market”\textsuperscript{15}.

2.4.7 Virgin Blue Not Dependent on Discount Travelers

The evidence provided to the Council to date by Virgin Blue asserts that the airline is more vulnerable because of its dependency on discount travelers. The Centre for Asia Pacific


\textsuperscript{15} \textit{Virgin Blue Continues to Soar}, Virgin Blue press release, 15 May 2003.
Aviation has produced a detailed report on Virgin Blue which dispels this myth\textsuperscript{16}. Among its comments on the overall and comparative strength of Virgin Blue, the Centre noted that Virgin Blue has a smaller spread of airfares, but concludes that it must sell a higher proportion of full-economy fares than Qantas to maintain its yield profile\textsuperscript{17}.

The Centre also observes that Virgin Blue’s business model is well-suited to the Australian market “with its high reliance on corporate and government travelers, and focus on east coast routes”\textsuperscript{18}. It goes on to note that “Virgin has managed to penetrate the all-important business travel market by securing sales from 50% of the top 50 companies in Australia, the Queensland Government and a number of government agencies.”\textsuperscript{19}

SACL also notes recent comments by Virgin Blue’s Chief Executive, Mr Brett Godfrey, that 20% of the airline’s passengers are now business travelers with registered corporate accounts with Virgin Blue\textsuperscript{20}.

2.4.8 No impact on Competition of Passenger-based Charges at Other Airports

Virgin Blue has objected to Sydney Airport’s introduction of a passenger based charge for domestic runway services of $2.88 per passenger. However, there is no evidence that higher, passenger-based charges at many of the airports in Virgin Blue’s route network have been an impediment to the airline’s ability to compete and expand services. The attached table shows charges at those airports in Virgin’s network that impose a PSC for runway services. It is to many of these same airports that Virgin Blue has introduced new services or significantly increased services, including:

- Launching Sydney - Canberra (PSC $5.51) services from 6 June 2003\textsuperscript{21};
- Launching Sydney – Alice Springs (PSC $4.98) from 5 June 2003\textsuperscript{22};
- Launching direct Sydney – Darwin (PSC $4.98) flights\textsuperscript{23};
- Doubling of services between Melbourne (PSC $3.17) – Hobart (PSC $4.00) from November 2002\textsuperscript{24};
- Launching Sydney – Launceston (PSC $4.00) direct daily services from 15 December 2002\textsuperscript{25};
- Expanded, “business friendly” services from Melbourne (PSC $3.17) – Perth (PSC $3.60) and Sydney – Perth from 15 September 2003 and 27 October 2003 respectively\textsuperscript{26};
- Significant growth of flights to the Gold Coast (PSC $5.36)\textsuperscript{27}.

\textsuperscript{16} Virgin Blue - Luckiest Little Airline Alive? Where to Next?, “Centre for Asia Pacific Aviation, June 2003
\textsuperscript{17} Ibid, page 10.
\textsuperscript{18} Ibid, page 5.
\textsuperscript{19} Ibid, page 10.
\textsuperscript{20} Virgin Threatens 40% Price Cut to NZ, Sydney Morning Herald, 7 August 2003.
\textsuperscript{21} Virgin Blue Launches Key Sydney – Canberra Route, Virgin Blue press release, 6 June 2003.
\textsuperscript{22} We’ve Spread Our Wings to Alice Springs, Virgin Blue press release, 5 June 2003.
\textsuperscript{23} Virgin Blue Stakes Claim to More Territory, Virgin Blue press release, 7 May 2003.
\textsuperscript{24} Virgin Blue Increases Services in Time for Christmas, Virgin Blue press release, 11 November 2002.
\textsuperscript{26} Top of the Morning to Perth Business Travelers, Virgin Blue press release, 16 May 2003.
\textsuperscript{27} Gold Coast Becomes Virgin Blue’s Fastest Growing Port; and Virgin Blue to Launch Direct Canberra – Gold Coast Service, Virgin Blue press releases, 1 July 2002 and 8 August 2003.
This is not altogether surprising. Low fare airlines such as easyJet and Ryanair have grown to become the most profitable and amongst the largest airlines in Europe, despite having a general policy of seeking simple per passenger charges at the airports they operate from.

3.0 Constraints on Ability to Exercise Market Power

The NCC has formed the view that SACL has an incentive to set charges for airport services at a level above the competitive level, but below the level that would attract government intervention.

To the extent that this is relevant to the Council’s assessment of criterion (a), SACL strongly opposes the contention that it has an incentive to, and would, set its charges at levels above competitive charges. Further, the facts in relation to Sydney airport’s actual pricing behaviour provide no support for the NCC’s contention. SACL’s conservative approach to charging was recognised by the NCC in its report, noting that:

- the charges determined by the ACCC in May 2001 approximate a competitive outcome;\(^{26}\)
- “there is no evidence that SACL is currently charging monopoly prices”\(^{29}\);
- there may be some justification for SACL to increase charges for aeronautical services;\(^{30}\)
- no submissions had suggested that SACL’s charges were above competitive levels;\(^{31}\)
- the opinion of Frontier Economics was 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”.\(^{32}\)

3.1 Behaviour Under a Light-handed Regime

Virgin Blue has asserted that if you “assume prices for aeronautical services have in the past been constrained by regulation to levels that approximate competitive levels...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”\(^{33}\).

However, this is an overly simplistic interpretation of business behaviour, which is not borne out by the facts. In making pricing decisions, SACL is faced with a wide range of pressures, including:

- marketing to new airlines;
- the long term development of the airport;
- relations with its major customers;
- broad political considerations (the airport is reliant on a wide range of decisions in areas including noise, the wider environment, security, safety, surface access, aviation policy and development plans and taxation, for which favourable political decisions are required);

\(^{26}\) Application by Virgin Blue for Declaration of Airstide Services at Sydney Airport, Draft Recommendation, National Competition Council, June 2003, paragraph 6.225.

\(^{29}\) Ibid, paragraph 6.252.

\(^{30}\) Ibid, paragraph 6.227.

\(^{31}\) Ibid, paragraph 6.228.


\(^{33}\) Response to Second Submission Lodged by SACL, Virgin Blue, 13 May 2003, page 11.
• ACCC and public disclosure and scrutiny of pricing, earnings and returns; and

• specific regulatory threats and informal government intervention.

These make it extremely unlikely that the simplistic price maximisation proposed by Virgin and its advisers would be in the interests of SACL or its shareholders.

3.1.1 Rational Airport Behaviour under Light-handed Regulation

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.

As it happens, the major airports have responded to light-handed regulation in exactly the manner that one would expect – they have entered into multiple year pricing agreements, based on sound economic pricing principles, that give the airports and airlines pricing certainty, comfort over service levels and provide for a program of efficient investment. That such agreements have been reached with airlines by Melbourne, Brisbane and Perth airports is more than a coincidence – it firmly demonstrates the incentive of the airports to use their market position responsibly, within a transparent commercial framework.

SACL has advised its airline customers that it anticipates moving down a similar path from next year, once its master plan has been accepted by Government and it has a blueprint for its investment requirements. That is, of course, if SACL is allowed the flexibility to do so.

Sydney Airport does not operate in an environment of numerous poorly informed customers. SACL’s approach to, and levels of, aeronautical charges need to be based on sound economic pricing principles and withstand the scrutiny of its highly organised and sophisticated airline customers. The airlines serving Sydney Airport also hold a high profile with the public and government. Individually, and collectively through bodies such as the Board of Airline Representatives and IATA, they are able to mount effective opposition to airport behaviour that they consider to be unjustified.

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.

3.1.2 Credible Threat of Re-regulation

SACL considers that the threat of re-regulation provides a credible and substantial constraint against attempts by it to unjustifiably raise charges or adversely affect competition in any airline market. The difficulty in seeking to price at a margin above competitive levels, in the hope of increasing revenue without attracting re-regulation, is that an airport does not know at what point above proxy competitive charges the government may intervene. As Forsyth noted, “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.”

The level of uncertainty concerning the point at which the Government may intervene is exacerbated by the degree of discretion that the regulator has in determining what is an appropriate level of charges. The regulator must form views on a range of parameters.

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34 Privatisation and Regulation of Australian and New Zealand Airports, Peter Forsyth, 2001, page 19.
including the valuation of assets, appropriate cost of capital, and the proportion of assets used for aeronautical purposes. This scope for judgement can lead to relatively wide variations in views regarding appropriate charges. Attempting to charge monopoly prices at a margin below the point of regulatory intervention would risk not only misjudging the point of intervention, but the approach that would be taken in assessing charges against a competitive outcome.

3.1.3 Observed Behaviour an Indicator of Future Behaviour

The NCC’s initial approach has effectively closed the door to consideration of SACl’s actual pricing behaviour. In this instance, it has taken the view 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.”

Given the depressed aviation environment in which the airport has been operating, if the airport had the incentive and ability to charge above competitive levels and did not feel constrained by countervailing forces, it would surely have done so. Not only has SACl not sought to do this, but it has maintained its charges significantly below competitive levels. The rationale for the government’s decision to implement a probationary period of light-handed regulation was to allow airports an opportunity to demonstrate responsible use of their commercial position, which SACl clearly has done.

The NCC’s initial view is inconsistent with the Productivity Commission’s findings on the various incentives and constraints that would act to temper the potential for airports to exercise monopoly power. Importantly, it is also inconsistent with demonstrated behaviour by unregulated airports. The NCC has sought to isolate the effect of airline countervailing power; promotion of non-aeronautical revenues; and the threat of re-regulation in constraining monopoly behaviour. Each taken in isolation may not adequately constrain the incentive to monopoly price, but taken together, their influence is far more persuasive, particularly the threat of re-regulation.

In reaching its preliminary view, the NCC has also assessed the constraints in absolute terms, concluding that non-aeronautical revenue “on its own” is not a significant constraint on SACl’s pricing behaviour. The NCC accepted that “…there is a credible threat of re-regulation faced by airports that distinguishes the sector from other monopoly service industries”. However, it did not consider the threat to be an absolute constraint on the exercise of market power. Taken in consideration with the incentive effect of non-aeronautical revenues, it found that these were insufficient to “completely negate” SACl’s incentives to exercise market power.

Few things in life are absolute, and the NCC does not have to satisfy itself that an absolute constraint exists on monopoly pricing – that would require either a perfectly competitive market or formal price regulation. The appropriate consideration here is one of reasonableness - whether taken together, on balance, sufficient incentives exist for SACl not to exercise market power such that competition is materially harmed.

The Council has been presented with theoretical construct regarding factors influencing an airport’s behaviour outside of price regulation. It has not, however, been presented with actual evidence that these incentives and countervailing forces are inadequate to constrain exercise of market power. In fact, the behaviour of Sydney Airport to date, and that of the other major Australian airports, suggests that the balance of incentives and influences under

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light-handed regulation are operating to deliver outcomes consistent with the Government's policy intentions.

4.0 The Public Interest Criterion

4.1 Legal Considerations

SACL's advice from Mallesons is that the Council's draft recommendation does not properly construe and apply the public interest criterion contained in section 44G(2)(f) of the TPA. In particular, Mallesons considers that the draft decision has:

- misconstrued the criterion by reversing the onus;
- improperly "presumed" public interest;
- applied a test which is too narrow; and
- presented a conclusion not supported by the evidence before the Council.

These are discussed further in the attached Mallesons report.

4.2 Public Policy

4.2.1 Regulatory Risk

Sydney Airport was privatised on the basis of minimal regulatory intervention where the airport behaved responsibly with regard to pricing. Government acceptance of the liberal interpretation of Part IIIA reflected in the draft recommendation would be inconsistent with the clear intention of the regulatory regime in which the airport was privatised.

In addition, declaration of the Airside Service at Sydney Airport would have direct implications for other major Australian airports and perceptions of regulatory risk in Australia. It would essentially represent the third change in regulatory environment since the Phase One airports were privatised and create a high degree of regulatory and investor uncertainty. The implications, however, would extend beyond the airport industry.

The interpretation of the national access regime to cover declaration based on a presumption of future pricing behaviour would lead to uncertainty for infrastructure providers, as it would greatly increase the prospect of their assets being subject to declared access. This would threaten investor stability, as well as acting as a deterrent to capital investment in the face of possible regulatory intervention in pricing.

4.2.2 Clear Intentions of Government

SACL is concerned that the Council's initial position has not had adequate regard to the Government's clear statement of public policy that the major airports should be given the opportunity to develop commercial agreements with airlines under a framework of at least five years of light-handed regulation.

The threat of government intervention and potential re-regulation was stated as a remedy for unjustifiable pricing behaviour by airports, with access to Part IIIA also noted as another potential remedy. However, Part IIIA was clearly not intended to be called on to second guess the Government's views and Productivity Commission's findings and re-introduce price controls in the expectation that an airport may at some time in the future choose to limit access or engage in unjustifiable pricing behaviour.

An important nuance of the Government's decision to make the airports subject to Part IIIA was that the decision was not one of whether or not recourse to the national access regime was warranted, but whether airports should continue to be subject to the airport-specific
access regime under section 192 of the Airports Act. The section 192 regime provided a streamlined path to declaration under Part IIIA that was considered appropriate at the time for the newly privatised airports.

In determining that Part IIIA should apply to the airports, the Government was actually determining that a less intrusive access regime was appropriate going forward. It noted in its 13 May 2002 response to the Productivity Commission’s recommendations that that “Part IIIA provides protection for access seekers that have been unreasonably denied access to services eligible under the legislation”\(^{37}\).

The Government clearly did not foresee the Trade Practices Act being used for pre-emptive declaration to head off a potential exercise of market power in circumstances where no one has been denied access and there is no evidence of unjustifiable pricing behaviour. Had this been consistent with the Government’s intention, the essentially automatic declaration mechanism of section 192 of the Airports Act would have remained in place.

4.2.3 Implications of Declaration on Desirable Outcomes of Light-handed Regime

SACL has a clear policy, advised to airlines, of negotiating commercial agreements once the airport Master Plan has been agreed by Government. We foresee these commercial agreements incorporating multi-year certainty of aeronautical charges, an agreed capital works program incorporated into prices, and agreement on service levels.

The ability of SACL to reach a satisfactory agreement with airlines will be significantly compromised by a declaration of airside services. Not only will the negotiation process be protracted, but some airlines may use the threat of ACCC intervention to reduce the prospect of agreeing an outcome satisfactory to all parties, effectively stymieing the type of commercial outcome that the Government sought from light-handed regulation.

In any event, policy considerations aside, for the reasons set out in this submission, SACL does not consider that the essential criteria for declaration set out in section 44G(2) of the TPA are satisfied in relation to Virgin Blue’s application for declaration of the Airside Service.

4.3 Benefits of Declaration

While SACL does not accept at all that its has the incentive to price above competitive levels, we consider it worth exploring the types of levels of charging that may attract government intervention, and the estimated benefits that may be derived from regulation in such an instance.

4.3.1 Constraints on Exercise of Market Power

The NCC recognised that determining this level was speculative, but noted that prices 100% higher than competitive prices, as cited by Frontier Economics, would be likely to attract Government action. This is not a surprising view in the face of such extreme price changes, but does little to advance practical consideration of this matter. Indeed, in the absence of any substantive evidence on the levels of pricing at which a monopoly airport may charge, there would be little to sustain the Council’s initial hypothesis that “exercise of market power by SACL up to the point at which the threat of re-regulation constrains it from doing so, will adversely affect competition to a degree that is material”\(^{38}\).

\(^{37}\) Government Response to the Productivity Commission Report on Price Regulation of Airport Services, response to Recommendation 7, accompanying the joint media release by the Treasurer and Minister for Transport and Regional Services, 13 May 2002.

\(^{38}\) Application by Virgin Blue for Declaration of Airside Services at Sydney Airport, Draft Recommendation, National Competition Council, June 2003, Paragraph 6.207.
The recent case of Auckland Airport provides empirical evidence as to the margins above competitive levels that attract government intervention. The New Zealand Commerce Commission found that Auckland Airport had imposed charges for aeronautical services that it considered exceeded competitive levels by between 4.6% and 13% (see attached n/e/r/a report). Based on this behaviour, the Commerce Commission considered that government regulatory intervention was warranted. While, ultimately, the government deemed that the estimated benefits of regulation were not sufficiently different from the costs, this provides a useful precedent as to the magnitude of charges above competitive levels that may trigger re-regulation.

4.3.2  Estimated Benefits Not Material

Economic adviser, n/e/r/a, has undertaken a quantitative estimate of the benefits of regulation, assuming that regulation prevented Sydney Airport from imposing charges 25% above competitive levels, which SACL notes is higher than the levels that prompted government intervention in the case of Auckland Airport.

n/e/r/a has assessed the potential benefit from declaration as avoidance of the net social loss that may occur if aeronautical charges exceeded efficient levels. This is in contrast with the New Zealand Commerce Commission approach of estimating benefits based on excess returns to the airport, which represents a transfer between consumers and airports, rather than an overall loss of economic welfare.

n/e/r/a has found that charges set at such a level would be expected to price 3% of passengers out of the market for domestic passenger services, based on price discriminating, profit maximising airline behaviour. The net cost to the community of this is estimated as approximately $174,000 in a year.

This analysis demonstrates that, even if airport charges were increased above competitive levels, the effect on market consumption would be very small, and would be more closely related to the elasticity of demand of the least price sensitive passengers. In order to maximise their revenue, airlines would allocate the increase in airport charges to passengers travelling for business and not to those leisure passengers that are sensitive to price. Highly price sensitive, budget passengers would bear very little or none of the increase in charges, and would continue to pay discounted fares that cover the marginal cost of their carriage plus a contribution to the fixed costs per flight.

SACL notes that, in order to estimate the potential benefits of declaration, n/e/r/a has considered the change in consumption arising from changes in price. This does not, however, mean that consumption can be taken as a proxy for competition.

4.4  Costs of Declaration

On 13 June 2003, SACL provided the Council with a submission on the costs imposed by price regulation. In addition to direct costs, this submission identified the key indirect costs of price regulation of airport facilities as:

- inefficient production and distorted consumption of services because of incorrectly set prices;
- sub-optimal investment in airport facilities where prices are set incorrectly and present a disincentive to invest, or because of the uncertainty of future regulatory decisions over the significant useful life of new infrastructure assets;
- excessive operating costs where a disincentive exists under a regulatory framework to reduce costs; and
- wasteful strategic behaviour by airport operators and consumers of airport services.
This section explores further the indirect cost implications of re-regulation, were Sydney Airport’s domestic airside facilities to be declared. It supports these with estimates of the magnitude of expected costs.

4.4.1 Investment Distortion

Examples of the ways in which regulation of prices through access declaration would be expected to lead to distorted investment include:

a) Regulated prices set too low through regulatory error, attracting additional passengers and bringing forward planned investment. This would impose a cost to the community associated with the time value of investment costs.

b) Delayed investment because of regulatory inflexibilities, time taken to agree individual projects with airlines, and the possibility of postponed discretionary works because of disincentives to invest (such as uncertainty regarding cost recovery). This would impose a cost to the public arising from reduced ability to cater for demand at certain times.

As an example of (a), SACL anticipates investing approximately $75m in real terms towards the end of the next 10 years in terminal and apron works to cater for domestic precinct demand. If demand were stimulated by aeronautical charges set at inefficiently low levels, even if these projects were built only one year earlier than otherwise required, the opportunity cost of funds would be approximately $5 million, using a 6.8% real cost of funds.

Turning now to the possibility identified in (b) that investment in these projects was delayed by one year. SACL forecasts in the vicinity of 25 million domestic passengers in 10 years’ time. The methodology adopted by n/e/ra in estimating the benefit of declaration implied a net public loss where passengers were priced out of travel of $5.22 a passenger. If we adopt this estimate, and assume that 1% of passengers that wish to fly to or from Sydney are unable to do so because of temporary capacity constraints, this implies a cost of over $1 million.

Taken to its natural conclusion, a combination of excessive demand as considered in (a) and delayed investment identified in (b) could well lead to the need to construct a second Sydney airport, or significant additional airport capacity, being brought forward.

Figure 6.10 - 2023/24 (Phase 4) "Busy Day" Hourly Aircraft Movements
SACL's recently released draft Master Plan indicates that Sydney Airport is expected to be able to manage forecast traffic over the next 20 years. The above chart from the master plan shows forecast 'busy day' demand by 2023/24.

As can be seen, significant peak constraints are expected to be experienced in the mornings, and to a lesser extent in afternoons, with domestic traffic representing the largest proportion of movements. Clearly these are long-term projections, and the ability of Sydney Airport to adequately cater for demand will depend significantly on SACL being allowed the degree of commercial flexibility to manage demand and ensure that appropriate investment is undertaken in a timely manner.

In particular, the ability to cater for demand relies in part on a 70% increase in the average number of passengers per plane by 2023/24, shown in the chart below. Changes of this magnitude cannot be achieved without a flexible pricing regime and strong commercial relationships with airlines.

![Figure 6.6 - Average Number of Passengers per Flight](chart.png)

In its attached paper, n/e/la has considered the public cost of bringing forward the construction of a second airport. If we assume that a second airport or significant additional capacity is required in 2023/24, and that investment and demand distortion brings forward this requirement by one year, the estimated cost to society is over $80m in present value terms.

### 4.4.2 Operating Expenses

Price regulation reduces the incentive for an organisation to minimise its operating expenses. This view is supported by Peter Forsyth, who observed that under a 'cost plus' approach to price regulation, "the incentive to minimise costs and produce efficiently is weakened, since the firm can simply pass on the cost increases". If a given level of operating expenses can be justified to a regulator, these are factored into allowable returns. To the extent that a productivity factor is included in regulated charges, the organisation may not seek to reduce expenses below assumed productivity, as they recognise that lower levels of expenses will be factored in at the next pricing review.

[39 Replacing Regulation: Airport Price Monitoring in Australia, Peter Forsyth, presented to the German Aviation Research Seminar, November 2002.]
SAACL’s operating expenses for 2002-03 were $125.5 million. Based on 2002 results, aeronautical expenses represent approximately 65% of total operating expenses, excluding depreciation. In setting charges in 2001, the ACCC assumed that reductions in operating costs of 4% per annum could be achieved. If we use this as a benchmark and assume that, despite productivity savings, operating costs under re-regulation remain 4% higher than they would otherwise have been, this implies a cost of regulation of $3.3m in the first year alone, based on aeronautical operating costs of $82m.

The incentive to reduce operating costs under a light-handed regulatory approach is evident, with Sydney Airport currently in the process of significantly streamlining its cost structure to establish a more cost-effective business going forward.

5.0 Conclusion

A decision to declare the Sydney Airport Airside Service would not only preclude the benefits expected to be derived under light-handed regulation, but cannot be supported based on the evidence presented to the NCC.

The role of the national access regime is to promote competition. This submission demonstrates that declaration of the Airside Service at Sydney Airport would not lead to any material enhancement of actual competition or the conditions for competition in the market for domestic aviation services. It also demonstrates that the Council’s focus in its draft recommendation on individual competitors and the level of consumption of domestic aviation services are not appropriate considerations with regard to the promotion of competition criteria.

A theoretical view of the incentives for Sydney Airport to exercise market power fails to take into account the nuances of the environment in which the airport operates. Factors such as regulatory and public pricing scrutiny, the airport’s relationship with its well-informed airline customers, and broader regulatory interaction with government, operate along with the threat of re-regulation and non-aeronautical revenue incentives to effectively temper exercise of market power. This has been demonstrated by Sydney Airport and other major airports in Australia, and there is not reason to believe that this will change in the future.

Finally, any expected benefits from declaration (noting that these are not actually derived from increased competition) can be demonstrated to be significantly outweighed by the costs from distortion of investment and demand and unfavourable operating cost incentives.

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