Application by Virgin Blue for Declaration of the Airside Service at Sydney Airport

Virgin Blue Response to Draft Recommendation

12 August 2003
1. **INTRODUCTION**

This document contains the submissions of Virgin Blue in response to the Draft Recommendation of the National Competition Council (Council) dated June 2003 in relation to the Application by Virgin Blue for Declaration of the Airside Service at Sydney Airport (Draft Recommendation).

Broadly, Virgin Blue agrees with the findings of the Council and its recommendation that the Airside Service at Sydney Airport should be declared. However, Virgin Blue would like to comment on three important aspects of the Draft Recommendation. These are:

(a) the approach to market definition adopted by the Council;

(b) the Council’s analysis of whether access (or increased access) to the Airside Service would promote competition in a market other than the market for the services; and

(c) the Council’s examination of whether declaration is in the public interest, in particular, its treatment of the cost of regulation.

1. **MARKET DEFINITION**

For the purpose of analysing whether declaration satisfied criterion (a) under section 44G(2) of the *Trade Practices Act 1974* (TPA), the Council examined whether competition would be promoted in a national market for domestic passenger air transport services (Domestic Passenger Market).

Virgin Blue has previously submitted that the appropriate market in which the Council should consider whether declaration would promote competition in a dependant market is the market in which domestic (both interstate and intrastate) air passenger and freight transport services are supplied to and from Sydney (Sydney Domestic Market).\(^1\)

Virgin Blue continues to maintain that the product dimension of the relevant market should include freight services, and seeks to rely on its previous submissions in this regard. Virgin Blue does not wish to make further submissions on this aspect of the market definition adopted by the Council.

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\(^1\) see Virgin Blue’s Submission in response to the National Competition council’s Issues Paper dated 7 March 2003 and report prepared by Frontier Economics *Sydney Airport declaration application by Virgin Blue* dated 7 March 2003 (*First Frontier Submission*)
However, one issue it does wish to address further is the finding by the Council that the relevant market is a national market. Virgin Blue maintains that the relevant dependant market in which to assess the promotion of competition in relation to the Airside Service should be limited to flights to or from Sydney. To expand the definition of the relevant dependent market to include all flights in Australia is to understate the potential impact of SACL’s market power in the relevant dependent market. While Virgin Blue does not consider that this market definition point will affect the Council’s conclusion in relation to criterion (a) given the importance of flights to and from Sydney in even a broader Domestic Passenger Market, for the reasons set out below Virgin Blue invites the Council to reconsider its position in relation to the definition of the dependent market.

As the Council has rightly identified, market definition is a tool to be used in the determination of the particular issue at hand. As markets are defined to facilitate the analysis of particular issues, it is necessary to first identify the issue or conduct being assessed, and then to develop a market definition appropriate to assess the competitive impact of that conduct. Maureen Brunt described market definition as:

>a tool to facilitate a proper orientation for the analysis of market power and competitive processes - and should be taken only a sufficient distance to achieve the legal decision. The elaborateness of the exercise should be tailored to the conduct at issue and the statutory terms governing breach.\(^2\)

This passage has been cited and applied on a number of occasions by the Courts.\(^3\)

Williams and Norman explain this concept as follows:

> The market is defined because the definition assists in providing an answer to the question before the authority of the extent and nature of competition. Thus, in defining the market one should begin with the problem at hand and ask: what definition of market will best assist in analysing the processes of competition relevant to this case? We are not suggesting [an arbitrary approach]. Rather, we are suggesting that the starting point of any identification should be the problem at hand.\(^4\)


Similarly, Areeda and Turner state:\(^5\)

In economic terms, a 'market' embraces one firm or any group of firms which, if unified by agreement or merger, would have market power in dealing with any group of buyers .... One cannot determine the degree of market power that merits concern, or, consequently, the 'proper' market definition, without reference to the legal context in which the issue arises. One must consider what is under attack, the substantive rules of liability that govern the particular case, and the relief that is at issue.

It is also well accepted that relevant markets under the TPA may exist within broader markets. Deane J in *Queensland Wire Industries v The Broken Hill Proprietary Company*\(^6\) stated (at 50,013):

> The economy is not divided into an identifiable number of discrete markets into one or other of which all trading activities can be neatly fitted. One overall market may overlap other markets and contain more narrowly defined markets which may, in their turn, overlap, the one with one or more others.

At its simplest, the conduct that needs to be assessed in the present context is the ability of SACL to raise prices for the Airside Service (ie its market power) and the impact that that conduct may have on competition in a dependent market. It is therefore most appropriate to analyse that conduct in the market that is most directly dependent on the Airside Service or, put differently, has the closest link to that conduct. This is because it is in this market that the consequences of any use by SACL of its market power will be most profound. Adopting a broader market, such as a Domestic Passenger Market which encompasses flights that would not be affected by any increase in the price of the Airside Service, such as those between Melbourne and Perth, will understate the competitive detriment that may arise from an exercise of market power in the dependent market. The Council itself recognised in the Draft Recommendation that SACL was not constrained in the exercise of its market power by the existence of other airports:\(^7\)

> Airlines competing on routes into and out of Sydney Airport require the Airside Service. There is at present no feasible opportunity for airlines on these routes to bypass the need to acquire the Airside Service at Sydney Airport from SACL. Accordingly, SACL’s market power is not constrained through the existence of alternate sources from which competitors could acquire necessary inputs.

\(^5\) II Antitrust Law (1978) at 347-348.
\(^6\) (1989) ATPR ¶40-925
\(^7\) Draft Recommendation at paragraph 6.158.
However, the Council rejected the Sydney Domestic Market as the appropriate market definition. Effectively, it did so because it did not believe that the Sydney Domestic Market constituted a market for the purposes of the TPA.\textsuperscript{8}

While the Council recognises the established jurisprudence that market definition is a tool for the purpose of analysing the issue at hand, it also recognises that the test of substitutability (both demand and supply side) remains the key definer of markets (see paragraphs 6.9 to 6.14). The Council considers that it is not appropriate to alter a market definition arrived at by application of the substitutability test, so that the definition can be more easily linked to the specific activities of the monopoly service provider. Such an approach runs the risk that the relevant dependent market may be defined too narrowly. Thus overstating the competitive detriment that may arise from an exercise of market power in the dependent market by the monopoly service provider.

In concluding that the Domestic Passenger Market was the relevant dependent market, the Council relied heavily on the existence of supply side substitutability. It found:\textsuperscript{9}

Such evidence suggests that there are few limitations on the supply side substitution possibilities between routes in the medium to long term as the redeployment of aircraft between routes is feasible in response to changes in price, demand and profitability.

Virgin Blue believes that the Council’s approach to supply side substitutability is too abstract and divorced from the issue at hand. As a result, Virgin Blue believes that the Council has placed too much emphasis on the degree of supply side substitutability and that has resulted in an overly broad definition of the relevant dependent market.

Of course, that is not to say that the Domestic Passenger Market is not the appropriate market in which to analyse other conduct in the airline industry, such as a potential merger between two airlines in Australia. It is simply that, in the present context, it is not the appropriate market in which to analyse the impact of any use by SA CL of its market power in the market in which it supplies the Airside Service.

2. **PROMOTION OF COMPETITION**

2.1 **Incentive to Use Market Power**

Virgin Blue notes that in the Draft Recommendation the Council has continued to adopt the position that in order for it to be satisfied that access (or increased access) to the service would

\textsuperscript{8} Draft Recommendation at paragraph 6.79.
\textsuperscript{9} Draft Recommendation at paragraph 6.73
promote competition in a dependent market, the facility owner must have both market power and the incentive to exercise that market power.

In its submission to the Council dated 7 March 2003, Virgin Blue noted that this requirement appeared to introduce a purposive element into criterion (a) by requiring that the conduct of the monopoly provider have the purpose of adversely affecting competition in a dependent market. In the Draft Recommendation the Council responded:

The Council does not consider whether the service provider intended to harm competition through the exercise of market power. Rather, the focus is on whether a service provider has the incentive to exercise its market power such that its use will have the effect of adversely affecting competition in a dependent market.

This statement more clearly indicates that the Council requires that, in order to satisfy criterion (a), the monopoly provider absent declaration be likely to act in a manner that will adversely affect competition in a dependent market. Virgin Blue considers that this is inconsistent with the manner in which the Australian Competition Tribunal has interpreted the requirements of criterion (a), namely, that it “…does not consider that the notion of “promoting” competition requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased…”

Virgin Blue does not believe that under criterion (a), in addition to establishing that a service provider has market power, it is also necessary to establish that the service provider has an incentive to use that market power.

2.2 Threat of Re-regulation

The Council has said of the threat of re-regulation:

The Council considers that the threat of re-regulation would constrain SACL’s incentive to exercise market power to a greater extent than the constraint from non-aeronautical revenue.

Virgin Blue believes that the Council has greatly overstated the constraint that any threat of re-regulation would impose on SACL’s conduct because the reintroduction of pricing regulation is subject to the following uncertainties:

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10 Draft Recommendation at 6.119  
11 Re Sydney Airport at 6.119  
12 Draft Recommendation at 6.198.
(a) It is unclear what level of pricing or other conduct by SACL might trigger re-regulation. In its response\(^\text{13}\) to the Productivity Commission’s report,\(^\text{14}\) the Government stated that:

However, the Government will also maintain a reserve right to bring forward the review, or conduct a separate review, if it appears that there have been unjustifiable price increases. Where a review indicates that there is evidence of unjustifiable price increases, the Government could decide to re-introduce price controls. (emphasis added)

While the Government later sets out some review principles, the concept of “unjustifiable price increases” is not defined in sufficient detail to provide any certainty.

(b) Even if a Government review were to find “unjustifiable price increases”, it is not certain what form the reintroduction of price controls would take. The re-regulation may consist of the reintroduction of the price notification regime under the *Prices Surveillance Act 1983 (PSA)* that previously applied to Sydney Airport. If this was the case, then Virgin Blue notes that that regime imposed no absolute constraint on the pricing conduct of SACL. It merely imposed on SACL an obligation not to increase a price for a notified service until it had notified the Australian Competition and Consumer Commission (Commission). Regardless of the views of the Commission in relation to that proposed price increase, SACL was entitled to increase that price once the relevant notification period expired. Ultimately, the only consequence of increasing prices under the existing regulatory regime for notified services in the PSA (assuming that the relevant notice period had been complied with) is the threat of more rigorous regulation. To this end, if the threat of re-regulation is only the threat of the Airside Service being declared a notified service under the PSA, SACL has no greater prospect of being the subject of more rigorous price regulation as a result of it exercising market power than any other provider of notified services.

If the re-regulation were to take some other form, then it is likely that new legislation would be required. The requirement to involve parliament in any proposed new regulation would add additional uncertainty to any threat of re-regulation.

(c) Further, the process of re-regulation is inherently a political process which is likely to be influenced by concerns and issues other than competition concerns. This means that there must be uncertainty as to whether re-regulation would occur, regardless of the conduct of SACL and its effect on competition.

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\(^{13}\) Joint Press Release, Minister for Transport and Regional Services and Treasurer: Productivity Commission Report of Airport Price Regulation

Finally, Virgin Blue notes that the Council considered the effectiveness of the threat of regulation in relation to Part IIIA of the TPA. The Council concluded that:\(^{15}\)

In relation to the threat of declaration under Part IIIA, the Council does not consider that this is a sufficient constraint on the exercise of a monopoly service provider’s market power such that criterion (a) would not be satisfied. To conclude otherwise would defeat the purpose of declaration under Part IIIA.

Virgin Blue agrees with this finding, and believes that the same reasoning should apply to the threat of any other type of regulation that might apply to services provided by means of access to a facility that otherwise satisfy the relevant criteria for declaration.

A provider of a service that meets the criteria in Part IIIA will always face a theoretical threat of having the price of the services it offers regulated in some manner because, by definition, its services are provided through a facility of national significance and it has a considerable degree of market power. Therefore, to take into account any such threat of regulation (regardless of its source) as a reason not to declare the service under Part IIIA defeats the purpose of declaration under Part IIIA.

3. **Public Interest**

When considering arguments from SACL that declaration of the Airside Service is inconsistent with Government policy, the Council stated:\(^{16}\)

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

Virgin Blue agrees with the findings of the Council.

Virgin Blue notes that the Council has undertaken an analysis of whether the costs of regulation outweigh the benefits of regulation, presumably on the basis that where the costs of regulation outweigh the benefits of declaration, that declaration would not be in the public interest. Virgin Blue does not accept that in order to satisfy criterion (f), that the Council needs to be satisfied of such a net benefit.

However, without conceding that it is necessary to consider the costs of regulation, Virgin Blue agrees with the Council’s findings that:

\(^{15}\) Draft Recommendation at 6.194.

\(^{16}\) Draft Recommendation at 10.25.
10.62 The Council must be affirmatively satisfied that that the costs of declaration outweigh the benefits before it can determine that criterion (f) is not met. This is because of the presumption that declaration is in the public interest if criteria (a) to (e) are met and that declaration would not be warranted only if it was clear that the costs of declaring outweighed these benefits.

10.63 At this time, however, on the basis of the evidence before it, the Council is unable to be affirmatively satisfied that the costs of declaration outweigh the benefits that will be delivered by declaration.

If SACL wishes to argue that the costs of regulation are excessive having regard to the benefits flowing from declaration, it is for SACL to identify and quantify each of these costs and to allow such costs to be subject to public scrutiny and comment. SACL has not to date done this. Virgin Blue agrees generally with the comments made by the Commission in its letter dated 19 June 2003.

In any event, Virgin Blue does not consider that the costs of the arbitration framework under Part IIIA of the TPA could be such that declaration of the Airside Service would not be in the public interest given the significance of the facility and the amount of revenue generated by the facility. Virgin Blue notes that in the financial year to 30 June 2003, SACL generated total aeronautical revenue of $241.2 million (an increase of 17.1% on the previous year).17

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17 SACL Media Release dated 21 July 2003: “Southern Cross Airports Corporation Holdings announces 19% increase in earnings for Sydney Airport”