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

Virgin Blue Response to Submissions
Commenting on Draft Recommendation

30 September 2003
1. INTRODUCTION AND OVERVIEW OF RESPONSE

This document contains Virgin Blue’s response to several submissions which have been lodged 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).

Virgin Blue does not consider that the submissions that have been lodged in response to the Draft Recommendation opposing the Council’s draft decision to declare the Airside Service warrant the Council reconsidering its position. However, Virgin Blue would like to respond to some of the issues raised in those submissions.

A number of different submissions were received by the Council, largely from airport operators, but also from other government organisations such as the Productivity Commission (PC) and the Department of Transport and Regional Services (DOTARS). While most submissions were expressed in slightly different terms, those submissions which were opposed to the Council’s draft decision to declare the Airside Service shared 4 broad criticisms of the Council’s draft decision. The criticisms can be summarised as follows:

- declaration would not promote competition because the threat of re-regulation is sufficient of itself to restrain airports from setting prices for the Airside Service in excess of competitive levels;

- declaration would not promote competition because increasing the price of the Airside Service merely affects demand for services in the dependant market, not competition in the dependant market;

- declaration would be contrary to the public interest because it is inconsistent with the government’s policy of adopting a “light handed” approach to airport regulation; and

- declaration would be contrary to the public interest because the regulatory costs of declaration would outweigh any benefit that would result from declaration.

The first 2 of these 4 criticisms relate to the promotion of competition criterion, criterion (a) under section 44G of the Trade Practices Act 1974 (Act), and the other 2 relate to criterion (f), the public interest criterion.

None of the points made is new, and each was considered extensively by the Council in its Draft Recommendation.
Virgin Blue will first set out its broad response to each of these 4 arguments, and then will respond separately below to each of the substantive submissions lodged with the Council.

1.1 Threat of Re-regulation

Virgin Blue does not consider that the threat of re-regulation by the Government provides any significant constraint on the ability and incentive of Sydney Airports Corporation Limited (SACL) to charge prices significantly in excess of competitive levels for the Airside Service.

Clearly, airport operators have an interest in playing up this threat in order to avoid possible declaration of airport services that meet the criteria set out in Part IIIA of the Act. However, Virgin Blue refers to section 2.2 of its submission to the Council dated 12 August 2003 in response to the Council’s Draft Recommendation (Virgin Blue Response to the Draft Recommendation) and notes:

(a) it is unclear what level of pricing or other conduct by SACL might trigger re-regulation;

(b) it is not certain what form “re-regulation” would take, even if the Government were to decide that there had been “unjustifiable price increases”; and

(c) re-regulation would be an inherently political process which is likely to be influenced by concerns other than competition and efficiency concerns.

In relation to paragraph (c) above, Virgin Blue notes that since the Council issued its Draft Recommendation, the threat of re-regulation appears even less of a constraint given the position adopted by the Minister for Transport and Regional Services and the Department of Transport and Regional Services (DOTARS). On 11 September 2003, the Sydney Morning Herald published an article titled “Airports unlikely to come back under control: Anderson”. This article stated in part that:

The Federal Minister for Transport, Mr John Anderson, signalled that the Government would probably reject moves to re-regulate airports as he outlined his own opposition to re-regulation.

In a speech to the Transport and Tourism summit earlier this week, Mr Anderson said that the present approach to handling airports was “working well”.

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1 This term was used by the government in its response to the Productivity Commission’s Report Price Regulation of Airport Services.
The submission dated 15 August 2003 lodged with the Council by DOTARS also provides an interesting insight into the sort of behaviour from airports that the Government would require before considering re-regulation. In misstating the position adopted by the Government following the Productivity Commission’s review of airport service regulation, the submission from DOTARS dated 15 August 2003 (DOTARS Submission) states (page 7):

Reliance on regulatory control (whether for access and/or pricing outcomes) was considered best used as a last resort, to be relied upon only where it was evident that an abuse of power (market failure) was actually taking place and required correction through regulatory mechanisms.

The DOTARS submission suggests that the Government would only consider regulation of airports justified in circumstances where it is evident that there is an abuse of market power by an airport.

Given the positions of the Minister for Transport and Regional Services and DOTARS, it is difficult to see how the threat of re-regulation imposes any significant constraint on SACL’s pricing. Virgin Blue does not believe that DOTARS is interested in any serious review of airport charges – it has not showed any interest in reviewing SACL’s recent price increases in relation to the Airside Service.

Nevertheless, NERA, in its report prepared for SACL and lodged with the Council (NERA Report), states on page 10 that it considers a 25% price rise to be “well beyond any price level that SACL could sustain without re-regulation”. While this statement is examined in more detail in the report prepared by Frontier Economics in response to the criticisms of the Draft Recommendation (Frontier Economics Report), Virgin Blue finds it very difficult to understand how NERA could support such an assertion when immediately following the relaxation of price controls, a number of airports in Australia raised their prices by far more than 25% without any opposition or protest from the Government. For example, the submission lodged on behalf of Melbourne Airport in response to the Draft Recommendation (Melbourne Airport Submission) notes on page 4 that following the relaxation of price controls in July 2002, the following price increases were implemented by airports: 35% at Melbourne Airport, 44% at Brisbane Airport and 51% at Perth Airport.

1.2 Declaration Only Affects Demand, Not Competition

The submission lodged by SACL dated August 2003 (SACL Submission) argues on page 2 that declaration would not promote competition because:

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 of 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 a similar vein, the submission lodged by SACL’s legal advisers (Legal Advisers Submission) states on page 4 that:

It is not to the point to suggest that, if access were offered at a lower price, the demand for access would increase as a result of increased sales in the downstream market. An increase in sales is not a promotion of “competition”, but merely an increase in the level of supply and demand (or an increase in the size of the downstream market). It does not, of itself, involve any improvement in market structure or in the process of competition.

Virgin Blue does not agree with these arguments, and responds as follows:

(a) First, charging a price in excess of competitive levels has been accepted by the Council to adversely affect competition in a dependent market. In The National Access Regime: A Guide to Part IIIA of the Trade Practices Act 1974, the Council states on page 83:

In essence, the service provider has three means by which it may seek to use its presumed monopoly power to adversely affect competition in a dependent market:

(a) the service provider may charge monopoly prices for the provision of the service; …

Virgin Blue also refers to section 2 of the Frontier Economics Report, which details how charging a price in excess of competitive levels will detrimentally affect competition.

(b) Secondly, the argument advanced by SACL and its legal advisers takes no account of competitors adopting different business models. The argument assumes that increases in a particular input price impact on competitors equally. This is not the case. As the Council noted in the Draft Recommendation (paragraph 6.143), low fare airlines have focussed on attracting passengers into the market that may not otherwise travel, and, accordingly, such airlines are more likely to carry a higher proportion of the more price sensitive passengers. As Virgin Blue has noted previously, because it carries a greater proportion of price sensitive passengers than Qantas, the impact of an increased input cost would have a greater impact on Virgin Blue than it would on Qantas.

(c) Finally (and conclusively, in Virgin Blue’s view), the argument put forward in the SACL Submission and the Legal Advisers Submission only considers the level of the charges
imposed by SACL, not the manner in which such charges might be imposed. However, declaration would allow the Australian Competition and Consumer Commission (ACCC) to make determinations in relation to the terms and conditions of access to the Airside Service (see section 44V(2)(c)) – which would encompass both the overall level of charges as well as the manner in which they are levied. Further, the manner in which SACL charges for the Airside Service is very important to Virgin Blue since the recent change by SACL to per passenger charges has increased Virgin Blue’s charges for the Airside Service by 50% while not having any significant impact on the level of charges paid by Qantas. This change has placed Virgin Blue at a competitive disadvantage.

In fact, SACL itself recognises that the manner in which charges for the Airside Service are levied may have an important impact on competition in the dependent market. SACL states on page 3 of the SACL Submission that:

> 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.

While Virgin Blue cannot see how a change in charges which rewards a dominant airline at the expense of a relatively new entrant could encourage any other potential new entrant to enter, in this passage SACL does recognise that the manner in which it levies charges for the Airside Service may have a significant impact on competition in the dependent market, even if its conclusion on who will feel the brunt of that impact is wrong. The fact that the manner in which SACL charges for the Airside Service can have a significant impact on competition is also accepted in the DOTARS Submission, although it too echoes the mistakes made by SACL about what effect that impact will have. These issues are discussed in more detail below.

### 1.3 Declaration Inconsistent with the Government’s ‘Light Handed’ Approach

Opponents of declaration argue that declaration of Sydney Airport is contrary to public interest (and therefore contrary to criterion (f)) because it would allegedly be inconsistent with the “light handed” approach to airport regulation announced by the Government.
Virgin Blue is surprised by the weight placed on this argument in many of the submissions made to the Council.

As Virgin Blue has noted in its earlier submissions to the Council,² the so-called “light handed” approach to airport regulation announced by the Government in its response to the PC’s Report: Price Regulation of Airport Services (PC Report) always included the continued application of Part IIIA of the Act to airports. The Joint Press Release from the Minister for Transport and Regional Services and the Treasurer dated 13 May 2002 and headed “Productivity Commission Report on Airport Price Regulation” (Government Response), states as follows:

Recommendation 7 [from the PC Report]: All airports should be subject to the generic provisions of the National Access Regime in Part IIIA of the [Act] …

Response: The Government supports the application of the generic provisions of the Part IIIA to airports.

Therefore, far from being inconsistent with the Government’s policy, declaration of Part IIIA would be entirely consistent with the Government’s policy in relation to airport regulation, so long as the other declaration criteria were met.

Some submissions accept that the Government has stated that retention of Part IIIA is part of its policy position in relation to airports, but argue that the Government never intended Part IIIA to apply to airports unless some additional criteria were satisfied. However, these additional criteria do not appear in the Act or emerge from a complete reading of the Government Response, and are therefore no more than wishful thinking on the part of opponents of declaration. For example, the SACL Submission states on page 11 that:

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 [sic] “Part IIIA provides protection for access seekers that have been unreasonably denied access to services eligible under the legislation.”

However, a complete reading of the Government’s Response (the document from which the SACL Submission quotes) would reveal that it does not state that protection should be limited to the circumstances where an access seeker has been unreasonably denied access to services. Indeed, the Government’s Response also states that:

² See section 2.6 of Virgin Blue’s submission to the Council dated 13 May 2003, and section 8 of Virgin Blue’s submission to the Council dated 7 March 2003.
In the event that commercial agreement cannot be concluded in relation to access terms and conditions, the access provisions in Part IIIA of the TP Act provide recourse to arbitration for determining those conditions for ‘declared’ services. [Government Response to Recommendation 5]

...  

There is no compelling case made for the airports-specific access provisions to be continued and the Government agrees that all airports should be subject to the generic access provisions of Part IIIA of the TP Act. Part IIIA contains mechanisms for ‘declaring’ access to a service, and includes arbitration and enforcement mechanisms in the event that the access provider and seeker cannot agree on terms and conditions of access. [Government Response to Recommendation 7]

Finally, even if the Government had expressed an intention that Part IIIA of the Act should not apply to airports, or should apply to airports only in certain circumstances, Virgin Blue does not see how this is a relevant factor in the absence of Parliament amending Part IIIA of the Act. Virgin Blue refers to the arguments set out in section 8 of its submission to the Council dated 7 March 2003. SACL is clearly confused by the roles played by policy and legislation. The SACL Submission proceeds on the basis that government policy should override legislation (when the reverse is true), and criticises the Council because its Draft Recommendation gives far too much weight to Part IIIA of the Act as opposed to SACL’s view of the Government’s policy (SACL Submission page 1):

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.

1.4 Costs of Regulation Would Outweigh Benefits

As Virgin Blue noted in its submission to the Council dated 12 August 2003, Virgin Blue does not necessarily accept that it is necessary or appropriate for the Council to undertake an analysis of the costs or benefits of declaration under criterion (f).

Nevertheless, to the extent that such an analysis is relevant, the material provided to the Council on this issue does not establish that the costs of declaration would outweigh the benefits. Each of the arguments put forward by the opponents of declaration significantly underestimates the benefits of declaration and grossly inflates the costs of declaration. For example, the NERA Submission states that the greatest cost is that associated with the risk of regulatory failure causing the second Sydney Airport to be built either one year early or one year later than the assumed date of 2023/2024. NERA estimates these costs to be in the range of $7.3 to $12.9
million per year. However, in calculating these costs, NERA only takes into account the costs of delayed or early construction, not the benefits that would arise from delayed or early construction. Further, NERA does not explain how declaration in 2003 would affect the decision to build the second Sydney Airport in 2023/24 given that the Council is currently considering a period of 5 years for declaration (see paragraph 12.12 of the Draft Recommendation). On this basis, the current declaration would expire 16 years before the assumed date of the construction of the second Sydney airport.

Virgin Blue refers to section 4 of the Frontier Economics Report which sets out Frontier Economics’ criticisms of the approach in the SACL Submission and the Melbourne Airport Submission to calculating the costs of declaration.

Virgin Blue responds in detail below to the issues raised in each submission on the costs and benefits of declaration.

2. DETAILED RESPONSE TO SYDNEY AIRPORT SUBMISSIONS

Virgin Blue sets out below its responses to the 3 submissions lodged on behalf of SACL.

2.1 SACL Submission

Many of the arguments raised in the SACL Submission have been addressed above or are addressed in Virgin Blue’s response to other submissions. Therefore, Virgin Blue will not respond in this section of the submission to every point raised in the SACL Submission.

The SACL Submission concentrates on the promotion of competition and the public interest criteria.

2.1.1 Promotion of Competition Criterion

SACL argues on page 4 that Virgin Blue has been misleading in the information that it has provided to the Council on airport charges as a proportion of airfares. As noted on page 4 of the SACL Submission, Virgin Blue did state in its submission dated 7 March 2003 that runway charges can amount to “up to 10% of Virgin Blue’s commonly offered ticket prices”. SACL argues that this is misleading because, with the domestic PSC at Sydney set at $2.88, this would imply an airfare of only $29 one way.

However, SACL appears to have ignored a critical element of operating an airline – that aircraft have to land as well as take-off. All major airports in Australia charge for both take-offs and landings. In accusing Virgin Blue of being misleading, SACL has only included approximately half of the runway charges associated with a successful one way trip. Virgin Blue clearly referred
to runway charges in its submission, being those charged by airports for both the take-off and the landing.

SACL argues in its submission (pages 5-7) that Virgin Blue is a market incumbent and is opposed to per passenger charges for this reason, and goes on to state:

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 fares.

SACL has not produced any evidence to back its claim that all new entrant airlines favour per passenger charges over weight based charges. This is not surprising since per passenger charges have resulted in a 50% increase for Virgin Blue in its charges for the Airside Service while not resulting in any significant change for Qantas. Per passenger charges would be likely to have a similar effect on the charges payable by a low fare new entrant – ie they would increase the charges payable by a low fare carrier by approximately 50%. This is very high price to pay for a relatively small discount during the initial start up phase. It is therefore very unlikely that any low fare new entrant would prefer per passenger to weight based charges. Of course, a full service airline may take a different view and prefer per passenger charges because:

- they provide a small discount during start up; and
- more importantly, they remove a source of competitive advantage for low fare carriers.

This conclusion reinforces Virgin Blue’s argument that the manner in which SACL levies charges for the Airside Service has the potential to significantly impact competition (including new entry) into the dependent market.

The balance of SACL’s arguments in relation to criterion (a) relate to:

(a) disputing the findings of the Council in relation to the disproportionate impact that an increase in charges for the Airside Service would have on Virgin Blue compared with Qantas; and

(b) asserting that declaration would not promote competition due to existing constraints on SACL’s ability to exercise its market power.

In relation to the first of these arguments, the disproportionate impact on Virgin Blue is not the only manner in which excessive charges for the Airside Service would detrimentally affect competition (see section 1.2 above). In any event, Virgin Blue does not consider that there can be
any real doubt over the fact that, on average, Virgin Blue’s customers are more price sensitive than Qantas’ customers. In the PC’s submission to the Council dated August 2003 (PC Submission), the PC notes (on page 4):

There is broad agreement that Virgin Blue typically carries more price-sensitive domestic passengers than Qantas.

Business class passengers are far less price sensitive than other passengers, and Virgin Blue does not offer a business class, whereas Qantas does. SACL’s arguments about Virgin Blue’s profit margins and the number of business travellers on Virgin Blue (as opposed to business class travellers), even if they are correct, do not alter the fact that Virgin Blue’s passengers are on average more price sensitive than those of Qantas.

In relation to paragraph (b) above, SACL argues that it has no incentive to set the charges for the Airside Service above competitive levels. SACL points to a wide range of factors which it states would constrain it from charging above competitive levels, including the pressure to market to new airlines, relations with major customers, broad political considerations, and the threat of re-regulation. Virgin Blue does not consider that any of these factors provide any effective constraint on SACL’s ability and incentive to charge in excess of competitive levels. If factors such as “broad political considerations” had ever been an effective constraint on a monopolist’s pricing, then there would be little need for a number of provisions in the Act.

SACL then asserts that declaration is unnecessary because it has not yet charged above competitive levels, and indeed is currently charging “significantly below competitive levels” (page 9). Virgin Blue refers to section 3.1 of the Frontier Economics Report in relation to the appropriate characterisation of SACL’s current level of charges. Further, Virgin Blue does not consider that, as a matter of principle, SACL’s very recent behaviour is any indicator of SACL’s future behaviour (especially its future behaviour if the Council decided not to declare the Airside Service). In any event, Virgin Blue considers that SACL’s recent pricing behaviour (as evidenced by its decision in relation to per passenger charges) does not auger well for the future of competition in the dependent market absent declaration.

2.1.2 Public Interest Criterion

SACL contends that declaration would be contrary to the public interest, including for reasons it describes as regulatory risk. SACL states on page 10 of the SACL Submission that:

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.
This passage attempts to rewrite history in relation to the Government’s policy on airport regulation in advance of the privatisation of Sydney Airport. On page 6 of the Government Response, the Government stated very clearly that Part IIIA would continue to apply to airports:

The Government supports the application of the generic provisions of Part IIIA to airports.

...

Part IIIA contains mechanisms for ‘declaring’ access to a service, and includes arbitration and enforcement mechanisms in the event that the access provider and seeker cannot agree on terms and conditions of access.

On the next page, the Government went on to state:

The Government is mindful of the fact that bidders for Sydney Airport should have a clear position on the proposed economic regulatory framework. Accordingly, the Government’s response has been announced so that the prices oversight arrangements to apply are understood by bidders and can be taken into consideration in formulating final bids for Sydney Airport.

Therefore, despite SACL’s protestations, there could have been no doubt in any reasonable bidder’s mind when bidding for Sydney Airport that it was being sold into the generic provisions of Part IIIA of the Act. SACL attempts to characterise declaration of Sydney Airport as some new phase in airport regulation. This is clearly incorrect – there would be no change to the regulatory environment at all since Part IIIA has applied to airports at all relevant times since its introduction.

In relation to the arguments over the costs and benefits of regulation contained in the SACL Submission, Virgin Blue refers to the Frontier Economics Report and to Virgin Blue’s response to the NERA Submission set out below.

2.2 Legal Advisers Submission

Virgin Blue has reviewed the Legal Advisers Submission and does not consider that any of the arguments raised in it should affect the Council’s Draft Recommendation.

Virgin Blue makes the following responses to the Legal Advisers Submission. Virgin Blue will not attempt to respond to every issue raised in the Legal Advisers Submission, since many of the points are answered elsewhere in this submission, or by the Council’s Draft Recommendation.
2.2.1 Criterion (a) – the promotion of competition

The Legal Advisers Submission attempts to criticise the Council for the test it applied in relation to criterion (a) in the Draft Recommendation. Virgin Blue does not agree with these arguments.

By way of example, in paragraph 2.2 of the Legal Advisers Submission, the legal advisers criticise the use by the Council of the test of whether “access is likely to enhance the environment for competition in a dependent market” (emphasis in the Legal Advisers Submission). Yet this test comes straight from the Tribunal’s decision in *Sydney International Airport [2000] ACompT 1* (1 March 2000) (*Sydney Airport Decision*), where it stated at paragraph 106 that:

> The Tribunal does not consider that the notion of ”promoting” competition in s 44H(4)(a) requires it to be satisfied that there would be an advance in competition in the sense that competition would be increased. Rather, the Tribunal considers that the notion of ”promoting” competition in s 44H(4)(a) involves the idea of creating the conditions or environment for improving competition from what it would be otherwise. That is to say, the opportunities and environment for competition given declaration, will be better than they would be without declaration.

The Legal Advisers Submission also asserts that a consideration of criterion (a) should not extend beyond whether “securing access (or increased access)” would promote competition in a relevant market. The Legal Advisers Submission states that the Airside Service should not be declared because no one is alleging that they cannot obtain access (or increased access) to the Airside Service (see paragraphs 1.7 and 1.8). It states at paragraph 2.8 that

> … declaration of the Airside Service would not lead to access (or increased access) which would promote competition in any downstream market, as access to the Airside Service at Sydney Airport is already available to anyone who applies. SACL does not restrict access or otherwise impose any barriers which would prevent entry to a downstream market. Accordingly declaration would not remove any barrier which would “unlock a bottleneck so that completion can be promoted”.

However, the mere fact of access (or lack of access) is not the appropriate test under criterion (a). This was confirmed by the Tribunal in *Duke Eastern Gas Pipeline Pty Ltd [2001] ACompT 2* (4 May 2001) (*Duke Decision*) where it stated at paragraph 74:

> The object of the Code, and its structure, make it clear that criterion (a) does not have as its focus a factual question as to whether access to the pipeline services is available or restricted. Put in that way, the question would not take sufficient account of the terms on which access is offered. Rather, the question posed by criterion (a) is whether the creation of
the right of access for which the Code provides would promote competition in another market. The enquiry is as to the future with coverage and without coverage. We agree with the approach adopted by the Tribunal in *Sydney International Airport* in this respect. The Tribunal must have regard to the position as it now stands, insofar as it provides a reliable guide to the future without coverage. [emphasis added]

The legal advisers argue that the Council has not given criterion (a) any meaningful operation because on the Council’s approach, if criterion (b) is satisfied then criterion (a) would also always be satisfied. Virgin Blue does not agree with this criticism. Under the Council’s approach, it would still be possible for criterion (b) to be satisfied and criterion (a) not to be satisfied. An example would be where there were competing sources of inputs to the dependent market. In the case of the Airside Service, if other modes of transport were more effective substitutes for air travel, then it may well be that although it was uneconomical for anyone to duplicate Sydney Airport, declaration may well not promote competition in the dependent market for travel (whether by air or other mode).

The Legal Advisers Submission asserts at paragraph 1.7 that:

No one is alleging that they have been unable to negotiate reasonable terms and conditions with SACL, whether as to price or other matters.

Virgin Blue does not understand the basis for this statement. Virgin Blue considers the introduction of per passenger charges by SACL for the Airside Service to be unreasonable (as well as anti-competitive and inefficient), and Virgin Blue has not been able to negotiate any other more reasonable basis for these charges.

The Legal Advisers Submission also argues that the Draft Recommendation fails to distinguish between competition and competitors. These arguments have no force, as the Council dealt with this issue carefully in its Draft Recommendation. The legal advisers then quote a passage from the Draft Recommendation which refers to the fact that an increase in charges could adversely affect the commercial operability of low cost carriers such as Virgin Blue and then state (paragraph 2.26):

Taken to their logical conclusion, each of these assumptions set out [in the passage from the Draft Recommendation] also indicate that the price of any input (eg, any other service offered by SACL, aviation fuel or any other consumable) would have a greater impact on Virgin Blue than Qantas and therefore adversely affect competition.

This is, in fact, exactly Virgin Blue’s position. Any increase in the cost base of airlines in Australia will favour Qantas over Virgin Blue, because increased costs (if they apply to both Virgin Blue and Qantas) erode the competitive advantage that Virgin Blue has striven to establish.
to the benefit of consumers in Australia. As noted in section 3.3.3, real discount fares in Australia are far lower with Qantas and Virgin Blue than they were when Qantas and Ansett were operating, even though the number of airlines operating was the same in each case (2). However, the legal advisers miss this point and go on to assert:

In reality, competition is not being affected adversely. Virgin Blue’s concerns lie not so much with any exercise of market power by SACL but with the different business models of Virgin Blue and Qantas. This highlights the real fallacy of Virgin Blue’s application. It is not about access or increased access. Nor is it about promoting competition. It is about regulatory gaming and achieving a level of pricing which favours or suits a particular business model.

With respect, this passage highlights the failure of SACL and its legal advisers to understand the economics of running a low fare airline. Low fare airlines compete largely on price and aim to stimulate demand through low prices, and in order to do this they rely on certain cost advantages they have over full service airlines. The presence of a low fare airline (or airlines) is good for competition as discussed above. Higher input costs (such as increased charges for the Airside Service) erode this cost advantage and limit the low fare airline’s ability to compete against the full service airline, leading to a detrimental impact on competition. Virgin Blue’s application for declaration is motivated by its desire to keep input costs to competitive levels and thereby maximise its ability to compete against Qantas.

2.2.2 Criterion (f) – the public interest

Virgin Blue has addressed the arguments raised by the legal advisers in relation to criterion (f) elsewhere in this submission and in section 8 of its submission dated 7 March 2003.

2.3 NERA Submission

Virgin Blue refers to the Frontier Economics Report, which responds to many of the issues raised in the NERA Submission.

However, there are a number of additional points Virgin Blue would like to raise in relation to the NERA Submission. First, as noted above, Virgin Blue does not believe that there can be any serious doubt over the fact that Virgin Blue’s passengers are, on average, more price sensitive than Qantas’ passengers despite NERA’s attempts to muddy the issue. Virgin Blue is also concerned by the research conducted by NERA in this regard. NERA states that in the week commencing 4 August 2003, it examined the ranges of fares offered by Virgin Blue and Qantas for a one way trip from Sydney to Melbourne for travel in 1 month’s time. NERA states on page 3 that it came up with the following ranges of fares:

- Virgin Blue: $65 to $194;
On 26 September 2003, Virgin Blue conducted a similar review on the internet of available fares for one way travel from Sydney to Melbourne on 27 October 2003. Virgin Blue discovered that the one way business class fare for travel on Qantas from Sydney to Melbourne on that date was $518. This is far greater than the $332 fare found by NERA to be Qantas’ maximum fare. Virgin Blue then checked the price of a business class ticket on Qantas from Sydney to Melbourne on 27 November 2003 and 27 December 2003. In each case, the price of a business class fare was $518. Unless Qantas has recently increased the price of business class tickets by over 50%, NERA appears to have disregarded business class fares when considering the spread of Qantas’ fares versus Virgin Blue’s fares for the purpose of reviewing whether or not Virgin Blue’s passengers are, on average, more or less price sensitive than Qantas’ passengers. Given that business class passengers are accepted to be far less price sensitive than economy class passengers, this is a surprising omission.

Further, in section 2 of its submission, NERA does not properly state the relevant legal test for criterion (a) under Part IIIA. The NERA Submission states on page 7:

> While we very much doubt the narrower market definition to be valid, on either of the potential market definitions, the method of analysis should remain the same. That is, will access (or increased access) through declaration promote competition within the market, be that the domestic passenger market or within narrower discount, leisure and business markets.

> Both Virgin Blue and Qantas are established domestic airlines that compete in all segments of the domestic passenger market. It follows that Airside Service charges must increase to such an extent that it results in one of the airlines no longer offering services or significantly reducing services to the relevant market. In our view, the likelihood of this outcome has not been established by the NCC.

NERA therefore concludes that in order to satisfy criterion (a), the increased charges must result in an airline no longer offering services at all (ie exiting the market) or significantly reducing services. This statement is at odds with the Tribunal’s interpretation of criterion (a) in the Sydney Airport Decision and the Duke Decision. NERA has added additional requirements to the test (significantly reducing services) and has completely ignored the impact that the increase might have on the expansion of services or potential entry – both of which are highly relevant to a consideration of competition within the market.

A significant part of the NERA Submission comprises NERA’s calculation of what the impact on passenger numbers would be if SACL increased charges for the Airside Service by 25%, on the basis that this is the maximum amount SACL could raise its prices without re-regulation.
As noted in section 1.1 above, the 25% figure is impossible to accept as the maximum increase SACL could impose without re-regulation.

However, NERA concludes that the drop in passenger numbers from this 25% increase would be only approximately 33,000 on an annualised basis. NERA reaches this conclusion by assuming the following (page 15):

The values estimated in sections 3.1.1 to 3.1.4 were that:

- SACL aeronautical charges increase by $0.72;
- the average business class fare is $200 and $100 for leisure passengers; [emphasis added]
- the price elasticity for business passengers is -0.6 and -1.37 for leisure passengers; and
- airlines will minimise the impact of the increase in SACL charges through price discrimination and place all the increase on business travellers, resulting in business fares increasing on average $10.43.

Virgin Blue refers to section 3 of the Frontier Economics Report in relation to the price discrimination solution assumed by NERA.

However, Virgin Blue also believes that NERA has overlooked an important factor when carrying out this analysis – which is that Virgin Blue does not have a business class, and is therefore unable to deal with the price hike by increasing its business class fare (as NERA assumes). Indeed, if, as NERA asserts, the profit maximising response to this increase would be to increase only the business class fare and not the other fares offered, then Virgin Blue will clearly be placed at a competitive disadvantage by the fact that it does not have a business class, and the increase will therefore have a detrimental effect on competition in the dependent market.

Even if NERA’s assumptions were modified so that airlines instead tried to impose the increase only on its less price sensitive passengers (whether in business class or not), then an airline’s ability to do this will still depend on the proportion of less price sensitive passengers that it carries. Clearly, if one airline did have a business class (eg Qantas), then it would be better placed than other airlines to pass on the increase to such price insensitive passengers.

In any event, for the reasons outlined in section 3.4 of the Frontier Economics Report, the NERA reasoning is inconsistent with economic theory on price discrimination.
For these reasons, Virgin Blue believes that NERA’s analysis of the result of a price hike by SACL (and therefore the benefits of declaration) is unsound.

In relation to the costs of declaration, NERA measures two types of costs, direct and indirect costs.

The direct costs are based upon the estimated cost of an arbitration ($3 million) to the various participants (including the ACCC) and ongoing regulatory costs of $1.5 million each year for the industry as a whole, which over a 5 year period would amount to a net annual average cost of $1.8 million per year. There are a number of problems with this figure:

(a) the estimated costs of an arbitration to SACL ($1.5 million) are very high and appear more consistent with large pieces of litigation as opposed to an arbitration before the ACCC;

(b) it assumes that there will be an arbitration. As pointed out by NERA, the ACCC is yet to have arbitrated an access dispute under Part IIA of the Act. Ultimately, provided that each party acts in a fair and reasonable manner, there is little prospect of an arbitration. Virgin Blue has no intention of being unreasonable as ultimately it too will need to bear costs associated with any such arbitration. It will not incur these costs if there is little prospect of success; and

(c) there is no explanation of what the ongoing direct costs of $1.5 million represent. They are justified on the basis of an estimation by the New Zealand Commerce Commission in relation to the performance of its obligation under Part IV of the Commerce Act 1986 (Commerce Act). However, the regime under Part IV is not a negotiate/arbitrate regime but rather a price control regime. It is not appropriate to compare costs under these two regimes. Outside of an arbitration, it is difficult to conceive of any party incurring direct costs as a result of declaration. During such a period there would be a binding agreement in place between the parties and any costs incurred in managing this relationship would be costs that would need to be incurred in any case.

In relation to indirect costs, Virgin Blue refers to the Frontier Economics Report.

3. DETAILED RESPONSE TO DOTARS SUBMISSION

Virgin Blue’s key concerns with the DOTARS Submission are that:

- it characterises Virgin Blue’s application to the Council in an inaccurate and unfair manner;
• it presents an inaccurate picture of the Government’s own stated policy in relation to airport regulation; and

• it is a non-responsive submission in so far as it does not address the issues that are relevant to the access provisions of the Act.

3.1 Unfair Characterisation of Virgin Blue’s Position

The DOTARS Submission unfairly characterises Virgin Blue’s motivation in applying to the Council for a recommendation that the Airside Service be declared. The submission states:

> It should also be noted that the use of the Part IIIA provisions of the Trade Practices Act 1974, in relation to an application for declaration that may advance a commercial position is not supported by DOTARS. In that regard, section 44F(3) of the Act provides a discretionary safety-net for the Council. [page 2]

> It is also important that the NCC give full consideration as to whether an application has been made in good faith. [page 14]

Virgin Blue completely rejects the implication in the DOTARS Submission that its application to the Council was not made in good faith. Virgin Blue lodged its application because it was unable to reach a commercial agreement with SACL over landing charges and was concerned that SACL would seek to impose unreasonable charges.

DOTARS, in its submission, implies on pages 17 and 18 that Virgin Blue’s application in relation to the Airside Service was somehow improper and that it was brought for the purpose of putting pressure on SACL in relation to a dispute over terminal access. Virgin Blue rejects this allegation.

Virgin Blue lodged its application in relation to the Airside Service for reasons that are wholly connected with SACL’s refusal to provide Virgin Blue with any certainty over landing charges and the ability and incentive that SACL has to exercise its market power.

Part IIIA is designed so that companies that use certain services can seek declaration of those services if they are unable to reach agreement with the owner of the infrastructure over the terms and conditions of access. This fact was expressly recognised in the Government Response:

> Part IIIA contains mechanisms for ‘declaring’ access to a service, and includes arbitration and enforcement mechanisms in the event that the access provider and seeker cannot agree on terms and conditions of access. [Government Response to Recommendation 7]
Obviously, the access seeker in each case would be looking to improve the position of its business through declaration and arbitration, and therefore “advance a commercial position”. Part IIIA is based on the idea that consumers and competition will benefit if access seekers can advance their commercial position through declaration and arbitration where this is warranted under the Act. It would be extremely rare for a party to apply for declaration of a service if it had no commercial interest in access to that service. In these circumstances, DOTARS’ statement that it does not support an application for declaration that “may advance a commercial position” is difficult to understand, as the logical consequence of such a position would be that DOTARS would almost never consider an application for a declaration, if made by an access seeker, to be one worthy of DOTARS’ support.

The DOTARS Submission states (page 18) that Virgin Blue’s application appears to be directed against the introduction of a more efficient pricing structure and “does not appear to DOTARS to be concerned with improving competition in the market place”. Ignoring for the moment the relevance of this issue to the declaration decision, per passenger charges are not more efficient than weight based charges (this is discussed in more detail below). Further, given the very large differential impact of the change in charges on Virgin Blue (a relatively new entrant with an efficient, low cost structure) compared with their impact on Qantas (an incumbent with a share of domestic air travel of approximately 70%), Virgin Blue does not understand DOTARS’ statement that the application is not concerned with competition.

3.2 Inaccurate Picture of the Government’s Policy in Relation to Airport Regulation

The DOTARS Submission presents an inaccurate picture of the Government’s policy in relation to airport regulation, which was clearly expressed in the Government Response.

The DOTARS Submission (page 7) states in relation to the Government Response that:

> Reliance on regulatory control (whether for access and/or pricing outcomes) was considered best used as a last resort, to be relied upon only where it was evident that an abuse of power (market failure) was actually taking place and required correction through regulatory mechanisms.

However, the Government Response contains no statement to the effect that regulatory control of access and/or pricing should only be relied upon where it was evident that an abuse of power was actually taking place. Instead, the Government Response actually supports the continued application of Part IIIA of the Act to airports, and notes that declaration under Part IIIA would be available where parties could not agree on access terms and conditions, as noted above in section 1.3.
In contradiction of this clear statement of policy, the DOTARS Submission adds a number of additional requirements and glosses to the operation of Part IIIA that simply do not appear in the Government Response. For example, on page 8, DOTARS states that it was envisaged that negotiations would have to “seriously” fail before recourse could be made “ultimately” to Part IIIA of the TPA and that it was intended that Part IIIA should only be relied upon where it is apparent that there is a “clear abuse of power occurring by an airport operator”.

These statements are inconsistent with both the Government’s own stated policy on the application of Part IIIA to airports, and the provisions of the Act itself. The declaration criteria under Part IIIA do not require there to be clear evidence of “abuse of power” and never have required such an element. Indeed, misuse of market power is dealt with under a different provision of the Act (section 46 in Part IV). The declaration criteria in Part IIIA only require the Council to be satisfied that declaration will promote competition in a dependant market. The DOTARS Submission is therefore at odds with the provisions of the legislation.

In any event, DOTARS appears to fail to realise that there is a real and significant issue over the change in the basis on which landing charges are levied. This is an issue that the ACCC will deal with in due course in the event that the Airside Service is declared.

Overall, the summary of the Government’s policy framework set out on pages 6 to 9 of the DOTARS Submission does not accurately reflect the Government’s policy with respect to the application of Part IIIA to airports as articulated in the Government Response. Nowhere does the DOTARS Submission recognise that the Government supports the ongoing application of Part IIIA of the Act, as it currently stands, to airports generally as noted in the extracts above from the Government Response.

### 3.3 DOTARS’ Understanding of Part IIIA and Relevance of the Submission

DOTARS appears to have a number of fundamental misconceptions relating to the operation of Part IIIA of Act.

As noted above, DOTARS appears to believe that clear evidence of abuse of market power by the service provider is required before a service can be declared under Part IIIA. This is simply not the position under section 44G of the Act.

The DOTARS Submission also appears not to accept that some airports have market power. On page 5 of the submission, there is a reference to the “abuse of any perceived market power” (emphasis added) by airports. This is surprising given that the PC found that a number of airports (including Sydney Airport) had substantial market power, and that the Government Response reported this finding without any disagreement (see response to Recommendation 1).
In relation to the relevance of the DOTARS Submission, it fails to put forward any probative evidence on any particular point relevant to the Council’s decision (such as SACL’s ability and incentive to use its market power). Instead, the submission merely sets out a summary of policy views (which, as noted above, are not consistent with the Government’s stated policy). A key statement can be found in the summary on p 13:

Declaration would not be in the public interest as it has the potential to undermine Government policy and efficient airport operations. [emphasis added]

However, for the reasons set out in section 1.3 above, the policy of the Government is not relevant to a consideration of the declaration criteria under Part IIIA of the Act.

The DOTARS Submission addresses at length the issue of per passenger rather than weight based charges. DOTARS’ position appears to based on the following incorrect assumptions:

- that per passenger charges are more efficient and pro-competitive compared with weight based charges;
- that declaration would somehow automatically result in Sydney Airport being forced to move back to weight based charges.

The question of whether or not weight based charges are more or less efficient than per passenger charges is actually not relevant to the declaration decision. The question of whether or not Sydney Airport should levy charges on the basis of passengers or weight will only be decided by the ACCC in the event that the Airside Service is declared. The ACCC will make this decision on the basis of different criteria from the declaration criteria (see section 44X of the Act), and while Virgin Blue firmly believes that the per passenger charges are anti-competitive, they are only relevant to the declaration decision because they are an example advanced by Virgin Blue of how (apart from simply charging monopoly prices) Sydney Airport’s exercise of market power could detrimentally impact competition in a dependent market.

Therefore, to the extent that large parts of the DOTARS Submission are based on the premise that the Council should not declare the Airside Service because declaration would automatically lead to weight based charges (see pages 11 and 16), the submission is misguided.

In any event, Virgin Blue disagrees with DOTARS’ assertion that per passenger charges are more efficient and represent a lower barrier to entry. On this point, DOTARS appears to have uncritically accepted some very simplistic arguments put forward by airports. DOTARS states that per passenger charges are more efficient because:

- they assist with congestion at capacity constrained facilities such as Sydney Airport;
they allow for easier entry and start up for airlines; and

they are pro-competitive because they “reduce airline variable costs” during a downturn.

Each of these assertions is incorrect.

3.3.1 Per Passenger Charging and Congestion

In relation to congestion, Sydney Airport itself has stated in one of its submissions to the Council that

.. SACL currently anticipates that capacity constraints will again occur sometime between 2009 and 2014. [Sydney Airport Supplementary Submission dated 30 April 2003, page 2]

In other words, Sydney Airport is not capacity constrained and does not expect to be so constrained for another 6 to 11 years. Despite this statement, DOTARS asserts in its submission (page 16) that:

For example, in a constrained operating environment, such as Sydney Airport, seeking ‘increased access’ through concessional charges could be meaningless if it leads to displacement of another operator who previously had access under comparable (ie the non-concessional) terms. Were the services to be declared this has the potential to deliver anti-competitive outcomes and seriously distort competitive neutrality.

While there are a number of comments that could be made about this passage, the relevant observation here is that it is based on a false premise.

The DOTARS Submission also refers to Melbourne Airport’s submission dated 5 February 2003, and quotes with approval the following passage (page 13) which supports passenger based charges on the (incorrect) basis that Sydney Airport is capacity constrained:

The question is whether the new pricing structure gives better signals for the use of the assets, especially where capacity is constrained, as is the case at Sydney Airport … A system that encourages larger aircraft would appear to be efficient at a capacity constrained airport and resistance would be likely to be driven by self-interest and not a genuine reason for regulation. [emphasis added]

Further, even if Sydney Airport were capacity constrained, Sydney Airport itself would not consider using per passenger charges to address the issue. In its Supplementary Submission to the Council dated 30 April 2003, Sydney Airport stated (page 2):
As capacity constraints again start to emerge, SACL will need to address them by encouraging increased average aircraft size and movement of traffic from the peaks to shoulder and off-peak times. While the best mechanism for doing this will need to be assessed more fully at the time, this would likely involve some combination of operational measures and demand management pricing, with the latter potentially including increasing peak charges, reducing off-peak charges and imposing minimum charges in peak periods.

Despite Sydney Airport’s own submissions to the Council acknowledging that it is not capacity constrained and, even if it were, it would address such issues through congestion pricing (not per passenger pricing), DOTARS argues that per passenger charging is more efficient because it assists with congestion at Sydney Airport.

3.3.2 Per Passenger Charges and New Entrants

The DOTARS Submission asserts that per passenger charges would be preferred by a new entrant compared to an incumbent because it “converts a significant fixed cost component of its airport fees to a variable cost base thereby allowing start-up airlines to share their operational risk with the airport operator.” DOTARS seems to be stating that per passenger charges would be a benefit to a new entrant because during its start-up phase when its load factors were low, it would be paying lower landing fees.

Per passenger charges are only beneficial to a new entrant while it is carrying fewer passengers per plane than incumbents. If it is carrying fewer passengers per plane than other airlines, it is unlikely to be profitable regardless of landing fees. Therefore, the reduced landing fees are likely to be small consolation for (and insignificant when compared to) the heavy losses. The strategy of any viable new entrant would be to increase the number of people it carries per plane as quickly as possible so as to match or exceed the number carried by the dominant carrier, Qantas. Therefore, any benefit is likely to be short lived if the airline is successful, and if the airline cannot significantly increase the number of people it carries per plane then it will inevitably exit regardless of the manner in which Sydney Airport levies landing fees. The only business model which would gain any lasting or meaningful benefit out of per passenger charges would be one that was based on carrying the same number of passengers per plane as the main competitor, Qantas, such as another full service airline.

DOTARS implies in its submission (page 11) that Virgin Blue may be seeking declaration because it is opposed to per passenger charging because per passenger charging would make it more difficult for Virgin Blue to defend its market share. This is a surprising claim, and it is not backed up by any analysis.

The actual effect of per passenger charging is to increase Virgin Blue’s overall landing fees by approximately 50% and to reduce Qantas’ landing fees by about 5%. If per passenger charging
made it more difficult for incumbents to protect their market share, Qantas would be opposed to it. Virgin Blue is not aware of any resistance from Qantas to the introduction of per passenger charging.

3.3.3 Per Passenger Charging and Downturns

DOTARS states (page 11) that per passenger charging “is generally recognised as facilitating competition by reducing the fixed cost component” facing new entrant airlines and being “counter-cyclical and pro-competitive” in that it reduces airlines’ variable costs.

Virgin Blue does not understand how a particular basis of charging can reduce both fixed costs and variable costs as DOTARS asserts. Nor does Virgin Blue accept that per passenger charging is “generally” recognised as facilitating competition.

As DOTARS notes, changing from weight based charges to per passenger charges converts a charge that is fixed for a particular flight to a charge that is variable according to the number of passengers carried. By definition, this actually increases the variable costs of airlines. This is not recognised by DOTARS in its submission – the only reference is then to the bald assertion that per passenger costs help reduce variable costs during a downturn. DOTARS must be referring to the fact that if a plane has a load factor of only 50% rather than 80% then it will pay less in landing fees if they are charged on a per passenger basis with the lower load factor compared to the fees it would have paid with the higher load factor.

But, clearly, if landing fees were not charged on a per passenger basis but were instead weight based the variable cost of landing fees would be $0, because they are a fixed cost once the decision is made to schedule the flight. Therefore, the obvious conclusion is that per passenger charges increase an airline’s variable costs (on a flight by flight basis) regardless of whether there is a downturn or not.

Per passenger charging actually reduces competition by raising all airlines’ marginal costs of offering seats for sale. This suits dominant incumbents as it raises the costs of all of their rivals (actual and potential).

By turning a cost which is fixed for an aircraft such as a weight based charge to a variable cost which is payable per passenger, per passenger charges increase the marginal cost to the airline of offering a discounted seat on the aircraft, and therefore reduce the extent to which airlines can discount. This has a detrimental effect on price competition generally.

The DOTARS Submission does not acknowledge the importance of the low fare airline model in providing competition and delivering benefits to the travelling public.
Virgin Blue, as a low fare airline, provides significantly more competition to Qantas than Ansett did when there were only Qantas and Ansett competing. The beneficiary of this increased competition is the travelling public. In real terms, prices for non-regional domestic economy air travel have been significantly lower in the period that Virgin Blue has been the principal competitor to Qantas. The Bureau of Transport and Regional Economics found that real discount fares in November 2002 were 23% cheaper than the real discount fares in November 1999.  

4. **DETAILED RESPONSE TO MELBOURNE AIRPORT SUBMISSION**

Most of the issues raised in the Melbourne Airport Submission have been dealt with elsewhere in this submission or in the Frontier Economics Report, and Virgin Blue does not intend to repeat its response to issues such as the alleged constraint imposed by the threat of re-regulation.

Virgin Blue does not consider that Melbourne Airport’s analysis in relation to the effect of increased airport charges on demand for airline services is helpful in any sense (see pages 3 – 6). Melbourne Airport simply presents aggregate information on the total number of international and domestic passengers and then concludes that this information does not provide evidence of any pricing events (increases in airport charges at different times at different airports) having any material effect on passenger numbers. Melbourne Airport then concedes that a detailed econometric analysis might reveal otherwise, but does not attempt any such analysis.

In a similar vein to SACL and DOTARS, Melbourne Airport also argues (page 9) that per passenger charges encourage competition compared with weight based charges. Once again, while Virgin Blue disagrees with the conclusion, it is at least recognition from Melbourne Airport that the manner in which an airport levies its charges can affect competition in the dependent market.

5. **RESPONSE TO OTHER SUBMISSIONS**

A number of other submissions were received by the Council in response to its Draft Recommendation. Most of these other submissions were submitted by parties that participated in the PC Review of airport regulation and their submissions reflect the positions formed during that process. Virgin Blue does not intend to respond to submissions which only raise arguments which have already been considered above.

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3 For more detail, see Virgin Blue’s submission dated 20 June 2003 to the ACCC in response to the proposed alliance between Qantas and Air New Zealand, especially at paragraphs 5.5 and 5.6.
Unsurprisingly, the PC Submission defends the conclusions that it reached in the PC Report. Virgin Blue notes that the conclusion in the PC Submission that declaration would not be in the public interest relies in large part on the fact that airports are constrained in their pricing of aeronautical services (such as the Airside Service) by revenue from non-aeronautical services.

This issue has been addressed at length in Virgin Blue’s previous submissions and in previous reports from Frontier Economics provided to the Council. Frontier Economics has demonstrated that revenue from these non-aeronautical services would not constrain SACL from increasing charges for the Airside Service by a factor of as much as 10.

Virgin Blue also notes that none of the airports that have lodged submissions with the Council have attempted to argue that this complementary revenue provides any significant constraint, even though they have argued that a wide range of other factors do (such as “broad political considerations”). Virgin Blue considers that these airports would be best placed to make any such argument, and that the only conclusion that can be drawn from their failure to do so is that complementary revenues do not provide any significant constraint on the pricing of the Airside Service.

The PC Submission also relies heavily on the fact that SACL has an incentive and ability to differentiate its pricing to airlines to encourage marginal users of the airport. The PC argues that this will represent a constraint on SACL’s pricing behaviour. Yet this hope is inconsistent with SACL’s actual position. SACL does not offer any significant differentiated pricing to encourage marginal users of the airport because of the problem of commitment, as outlined in section 2.2 of the Frontier Economics Report. Indeed, SACL’s attitude to price discrimination is set out clearly in the SACL Submission (page 3):

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. [emphasis added]

SACL is attempting to turn its inflexibility and refusal to efficiently price discriminate into a virtue. This approach to pricing by a monopoly is consistent with the position outlined in the Frontier Economics Report and indicates, contrary to the PC’s hopes, that efficient price discrimination by SACL is extremely unlikely.
For the reasons set out above, Virgin Blue considers that the PC significantly underestimates the benefits of declaration. For this reason, its conclusions on whether declaration would promote competition and whether declaration would be in the public interest are incorrect.

Finally, the PC Submission notes in parenthesis on page 2 that:

… importantly, the NCC has not found that Sydney Airport has or is exercising market power …

Both the PC in the PC Report (see page XVI) and the Council in its Draft Recommendation (see paragraphs 6.112 and 6.262) concluded that Sydney Airport had market power. Indeed, the Council went on to find that SACL had both the ability and incentive to exercise its market power (see paragraph 6.262). Virgin Blue does not understand the basis on which the PC asserts that the Council has not found that Sydney Airport has market power.

5.2 Submission from Professor Forsyth

Peter Forsyth, Professor of Economics at Monash University lodged a submission with the Council dated August 2003 (Forsyth Submission). Professor Forsyth states on the cover page of the Forsyth Submission that he is grateful to Dr Warren Mundy for comments on an earlier draft of the submission. Virgin Blue notes that Dr Mundy has a long association with Melbourne Airport, and indeed that he is a director of Bluestone Consulting, the company which prepared the Melbourne Airport Submission.

The Forsyth Submission concludes that declaration would not promote competition in the dependent market. Professor Forsyth puts forward arguments similar to those discussed in section 1.2 above. Professor Forsyth argues that reducing an excessive price for the Airside Service back to a competitive level would not of itself promote competition (page 4):

Declaration would result in all the competitors paying less for an input, but the balance between the firms would not be changed. It may well be that the facility owner was using market power, and that declaration forces prices down towards costs; however, all competitors will be comparably affected by this. There is no general reason to expect more firms to come into the market, or for existing firms to change how they price in relation to cost.

Virgin Blue disagrees with this argument, for the reasons set out in the Frontier Economics Report and section 1.2 above.

Professor Forsyth then argues that increases in the Airside Service will not have any differential impact on low fare airlines compared with full service carriers. WhileVirgin Blue does not agree with this proposition, the Forsyth Submission does not even address the third way in which
SACL may use its market power to the detriment of competition in the dependent market – through changing the manner in which it levies charges for the Airside Service.

Virgin Blue notes that the Frontier Economics Report also responds to a number of the arguments set out in the Forsyth Submission.