

# **Melbourne Airport**

## **Virgin Blue Application to have certain Services Declared under Part IIIA of the *Trade Practice Act 1974***

### **Response to the Draft Recommendation of the National Competition Council**

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## ***Executive Summary***

The Council must not make a recommendation to the Minister to declare the service in question unless it is satisfied that six criterion set out in Section 44G(2) of the *Trade Practices Act 1974* are met. The analysis set out in the Draft Recommendation is compelling in relation to four of the six criteria, specifically criterion (b), (c) (d) and (e).

In relation to criteria (a), that declaration must promote competition in a market other than the market for the service subject to declaration (the airside service provided by Sydney Airport), the Council has failed to pay due regard to a range of relevant facts including

- The impacts on domestic and international aviation markets of three separate increases at Sydney and other major Australian airports.
- The impact on domestic and international markets of the shift to passenger based charges at a range of major airports
- The conduct of major Australian airports under the Government's airport price monitoring policy introduced in July 2002.

A proper analysis of these facts shows that significant changes in airport prices over the last few years have had no material impact on demand or competition and that the Government's policy has been effective in constraining excessive use of airport market power.

The Council's conclusions have also been influenced by some simple, and in some cases incorrect, assumptions about the structure of the domestic aviation market and the business decisions and cost structures of airlines. This evidence has largely been presented by Frontier Economics on behalf of Virgin Blue.

The Council's analysis in relation to criterion (f), that declaration must not be against the public interest, is also incomplete. In particular, a more extensive analysis of the competition effects of regulatory failure is required as well as a consideration of the economy wide effects of deregulation, particularly with respect to how increased regulatory risk will impact on investment at other airports.

A detailed analysis of these issues is presented in this paper. When the Council's overarching framework is applied to the appropriate facts and correct economic analysis, the conclusion is that criterion (a) and (f) are not met and therefore the Council should not recommend declaration to the Minister.

## ***Introduction***

This paper address the Draft Recommendation released by the National Competition Council (the Council) released on 30 June 2003.

The Council must not make a recommendation to the Minister to declare the service in question unless it is satisfied that six criterion set out in Section 44G(2) of the *Trade Practices Act 1974* are met. The analysis set out in the Draft Recommendation is compelling in relation to four of the six criteria, specifically criterion (b), (c) (d) and (e).

As part of its analysis, the Council needs to determine what are the relevant services and facilities. Melbourne Airport has previously supported the definition of both the service and the relevant facility. Upon consideration of the Draft Recommendation, and in particular the Council's reasoning at 4.36, it may be the case that a smaller bundle of assets could make up the minimum bundle required to provide the service. In particular, it seems possible that the services in question (that relate to aircraft landing and movement services for domestic aviation) could be provided without the international terminal and associated facilities (such as aprons, car parks, and access roads). That said, whether the facility is the whole airport or some reasonable subset, the definition of the facility is not critical to the analysis set out in this paper.

As set out below, the Council has adopted the correct methodological approach in considering the most important of the six criterion set out in section 44G(2) – that is criterion (a). That said, the Council's conclusions are flawed due to a failure to consider a range of market evidence relating to Sydney and other major Australian airports and an uncritical over-reliance on the evidence and analysis provided by Virgin Blue and its consultants. This paper sets out a range of relevant information and provides an alternative economic view to that of Frontier Economics – a view that is informed by the proper facts and has greater explanatory power in relation to the available market evidence.

The Council's analysis in relation to criterion (f) is also incomplete. In particular, a more extensive analysis of the competition effects of regulatory failure is required as well as a consideration of the economy wide effects of deregulation. These issues are also discussed at greater length below.

### ***Criterion (a) - Promotion of competition in another market***

Of all the criteria that the Council must consider, the promotion of competition is the one at the core of the policy intent of the National Access Regime. It is also the criteria that is most difficult to assess, in that in many cases a view will have to be formed about outcomes in the dependant market that result from potential actions in the market for the service (or similar markets) that have not been previously witnessed.

The Council has adopted the correct methodological approach in considering this application. In particular, the Council is correct in proceeding from the point of having determined whether market power exists to asking if SACL has the incentive to use it, whether there are (market and institutional) constraints on its use and if it was used, whether competition would be effected in the dependant market (see 6.2).

The Council has reached a number of conclusions that are not contestable including

- Market definition and that if criteria (a) is satisfied in a broad market context, it will be satisfied in a narrower one (6.5).
- That SACL has market power as a general proposition (throughout chapter 6) although we believe it is effectively constrained by government policy and there is no evidence that its use within feasible ranges will impact on competition.
- That the way in which SACL is able to use its market power is limited to seeking to extract monopoly rents in the provision of the service by setting access terms and conditions (6.5, 6.116).
- That there is no need to show intent to harm competition (6.119).
- That SACL may act in a way that is damaging to Virgin Blue's private interests is not by itself sufficient to show criteria (a) is met (6.127).

Whilst the Council has adopted an appropriate methodological approach to considering this complex criteria, it has done so largely in the absence of any consideration of the facts as they exist in relevant markets. It has also relied on assertions and analysis provided by Virgin Blue (and its consultants) that are in places unsubstantiated, wrong and/or analytically flawed.

When these are corrected and other factual evidence is applied to the Council's methodology, it is not possible to conclude that if SACL were to use the market power actually available to it that it would affect competition in a material way. Moreover, as we understand the Government's policy, SACL's ability to use its market power to increase prices is limited. Set out below are a range of issues that are relevant in assessing this criterion.

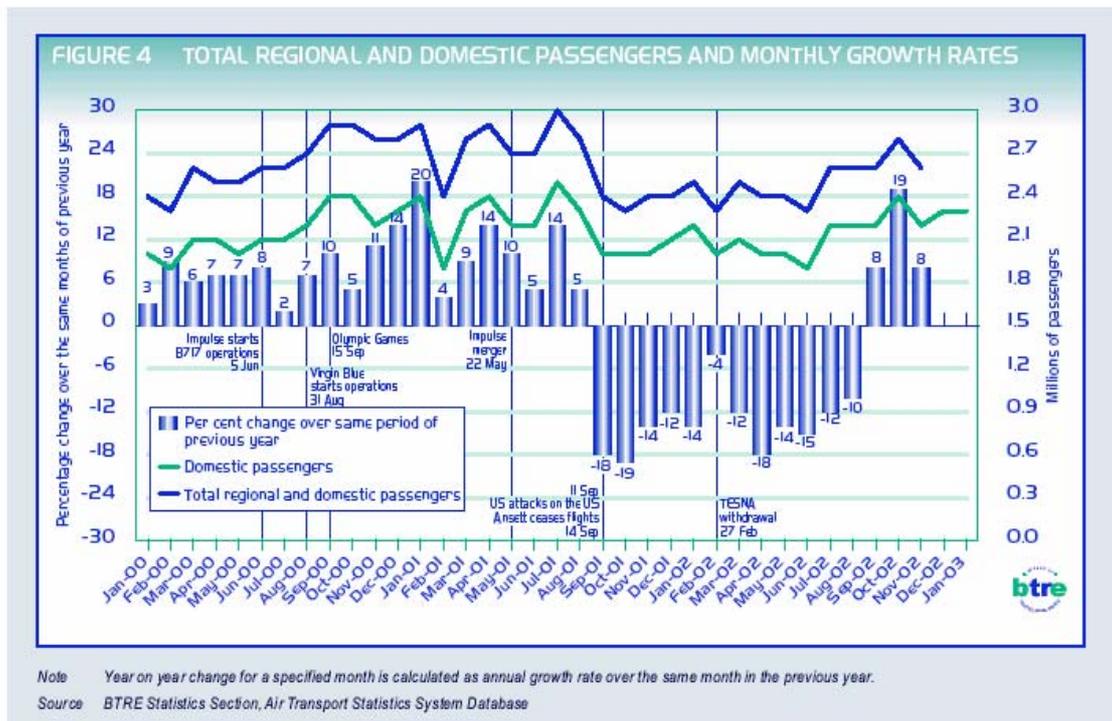
#### **Available market information**

In relation to the airside service, there are examples of outcomes in the dependant market resulting from SACL's past pricing behaviour. Further, there are also examples of outcomes at other major airports, and in particular Melbourne and Brisbane, that operate in essentially identical markets and possess effectively the same degree of market power. As far as can be ascertained from the Draft Recommendation, the Council has not considered this material.

There have been three significant pricing events since the airport sales process commenced in 1997:

- The 91% price increase allowed to SACL by the ACCC, implemented in May 2001.
- Price increases flowing from removal of price notification for Phase 2 airports and associated small rises allowed Phase 1 Airports following the events of September 2001 that flowed through during the last quarter of 2001 and early 2002.
- Significant price increases at Phase 1 (on average 35% in Melbourne, 44% in Brisbane<sup>1</sup> and 51% in Perth<sup>2</sup> – Melbourne and Perth also moved to domestic passenger based charges at this time) and some Phase 2 airports agreed with airlines following the Government's acceptance of the Productivity Commission's recommendations which took effect on 1 July 2002.

The following chart is from the Bureau of Transport and Resource Economics (BTRE) semi-annual *Avline* publication published in April 2003.



This data shows no evidence of the pricing events set out above having any material effect on domestic passenger numbers. Indeed, if it demonstrates anything it shows that the major factors driving passenger volumes in this period have been events of entry and exit and that since July 2002 (when all major airports other than Sydney significantly increased their prices) passenger numbers have been recovering significantly. Most importantly for the purposes of the Council's considerations, airport price increases,

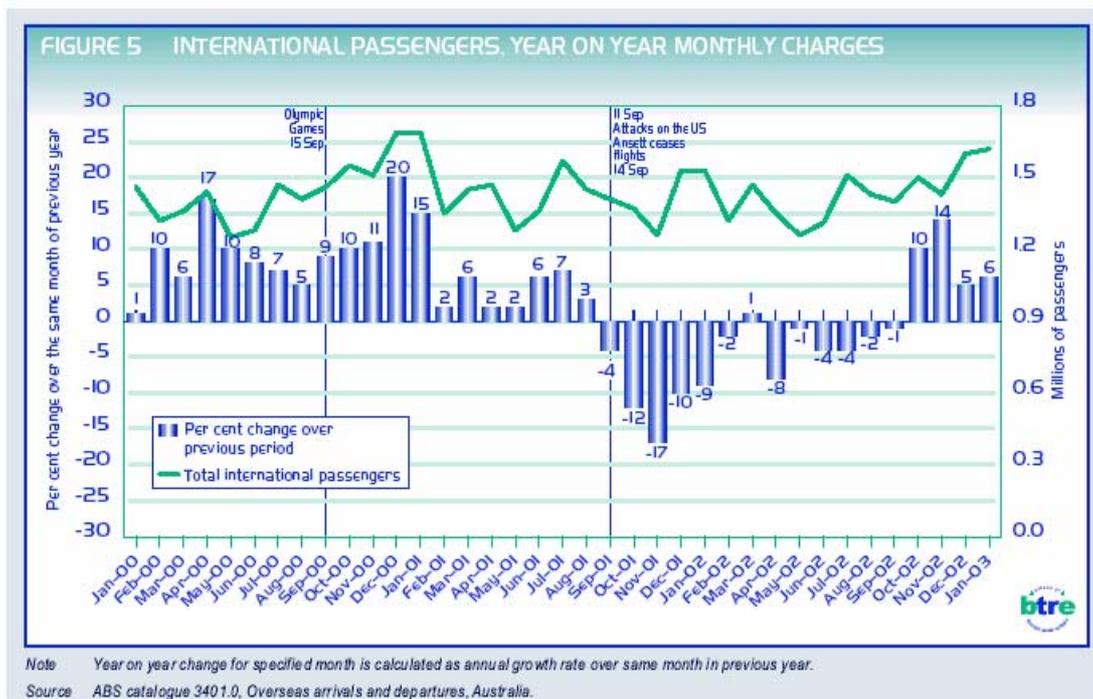
<sup>1</sup> Brisbane Airport Press Release *Brisbane sets record straight on aero pricing*, 16 July 2002

<sup>2</sup> Personal communication.

which have been significant in percentage terms, do not appear to have had any significant impact on demand since July 2002.

It has been suggested that increases in airport charges may impact more heavily on low-cost carriers such as Virgin Blue and in doing so may reduce competition in the dependant market (such as at 6.136). Whilst the proposition itself is arguable, Melbourne Airport's experience of the last twelve months, if anything, suggests that the contrary is true. Since Melbourne Airport increased its prices (and moved to passenger based charges) on 1 July 2002, an examination of publicly available schedules shows Virgin Blue has increased its share of domestic seat capacity from 22% to 34%<sup>3</sup>. During this period, Virgin Blue increased total monthly available seats by over 48% whilst Qantas reduced its seat capacity by more than 3%. On the basis of the argument put to the Council by Virgin Blue and its consultants, which must be as applicable to Melbourne as it is to Sydney, the opposite should have occurred.

Further evidence that final demand is not sensitive to airport price changes, below is found in chart below showing international passenger numbers over a similar period. It should be noted that similar pricing events occurred in the international sector and also all major airports moved to a passenger basis for charging for international services. Again, there is no evidence that these pricing events have effected the demand for international travel.



Whilst a detailed econometric analysis may reveal otherwise, the only conclusion that can be drawn at face value from both domestic and international evidence is that changes in airport charges do not impact final demand. This is a reflection of a general

<sup>3</sup> Actual passenger numbers are confidential but in any event capacity is a better indicator of competitive intent than actual utilisation.

proposition that for all practical purposes, final demand is highly inelastic with respect to airport charges.

If one accepts SACL is pricing somewhere just below “competitive levels”<sup>4</sup>, it is not possible to be satisfied “that SACL has the ability and incentive to price at such a level above competitive levels that the adverse effect on competition would be material” (6.175), if there is no evidence that SACL’s prices effect demand. The analysis put forward by Frontier Economics simply does not account for the market experience in relation to SACL’s May 2001 price increase and subsequent experience at other major (and indeed minor) airports.

The Council must consider the relevant market data carefully – something to date it has not done. Specific information on Sydney should be available either from airlines, SACL or the BTRE. If the Council persists with its current view and recommends declaration it should commission a truly independent analysis of the relevant data to ensure that whatever recommendation it makes to the Minister is not open to challenge on the basis the Council has failed to consider actual market outcomes.

### **Structure of the dependant market**

The Council correctly identifies monopoly in the dependant market as conditions where declaration may not lead to increased competition. It does not however consider any other possible market structures that may lead to significant structural impediments. In particular, duopoly and oligopoly are likely to lead to the same outcomes as monopoly. If there are structural impediments in the airline market, the pricing outcomes for airport services will largely act as a device for distributing rents between the airport and the airlines using that airport. This would account for the market experiences described in this paper.

A comprehensive analysis of the market structure of the dependant market is needed. Australian domestic aviation policy since the abolition of the Two Airline Agreement has largely been about addressing the duopoly that existed between Ansett and Qantas. As far as today’s industry structure, it is by no means clear that the sorts of structural impediments previously of concern are no longer present.

Whilst the names and roles may be different, the vast majority of major domestic aviation routes remain operated by at most two carriers and save for a small regional presence, the industry is a duopoly with Virgin Blue holding around 30% of the market and Qantas (and its subsidiaries) the rest. Virgin Blue operates on thick routes between major airports with frequencies that increasingly match Qantas’, especially in peak periods. This is in contrast with markets in Europe and North America where so called “low cost” carriers largely operate on thin routes between secondary airports and usually not in direct competition with major carriers.

The market Virgin Blue entered, and the aspirations it had when it did, are now no longer relevant. Any analysis assuming Virgin Blue exhibits characteristics of a low cost entrant carrier denies its significant market position and the way it is seeking to diversify throughout the value chain to develop the economies of scope that enabled both Ansett and Qantas to protect their positions throughout the 1990s.

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<sup>4</sup> We return to the question of whether “competitive levels” is the correct benchmark later.

Examples of Virgin Blue's growing scope include

- Securing long term access agreements to terminals which give them preference over certain elements of capacity.
- Development of lounge products.
- The provision of intermediate aviation services such as ground handling (to Rex), maintenance (to Trans Australian Air express) and pilot training (to the RAAF).
- Integration with international services.

This is not to deny the success of Virgin Blue's business model or its potential. In 1995, McKinsey and Company identified that economies of scale in fleet operations begin to develop in fleets of 40 to 48 aircraft of a single type<sup>5</sup>. Virgin Blue currently has a fleet of around 30 aircraft of similar type and has recently announced a major acquisition program<sup>6</sup> that would soon see it achieve the scale economies contemplated by McKinsey enabling it to contain unit costs and probably drive them even lower.

This ability to drive lower costs is what is creating a major challenge for Qantas. Coupled with a more basic service offering, it is its cost structure that enables Virgin Blue to offer lower prices. These cost conditions are, however, precisely the same as those that characterise firms with market power, including those operating in duopoly and monopoly markets. It is highly unlikely that any new entrant would have unit costs as low as Virgin Blue; and given the "war chest" Virgin Blue has recently announced<sup>7</sup>, it is well placed to undertake what the new Chairman of the ACCC has described as "vigorous lawful competition" in response to any entry threat. This is in contrast to the position that Ansett found itself in when faced with similar competitive threat from Impulse and Virgin Blue in 2000-01.

On 15 May 2003, Sir Richard Branson said in Adelaide that Virgin Blue had

... the best EBITDAR (*sic*) per plane of any airline in the world. This they achieved by beating Ryan Air and Jet Blue by half a million US dollars per plane and Qantas by \$900 000 (Virgin Blue 5.3, Jet Blue/Ryan Air 4.8 each and Qantas 4.4 million). For interest Ryan Air still has the best EBITDAR margin in the industry at 36%. However Virgin Blue is a much younger and smaller airline with only 30 planes ...<sup>8</sup>

This quote is instructive for a number of reasons. It shows that low-cost carriers as a class have relatively high margins. Secondly, it appears Sir Richard has some expectation that margins will improve as the fleet grows. Finally, assuming Qantas generates greater revenue per plane (as it charges higher fares and carries more people per plane as they are on average bigger) then its margins must be lower not higher than Virgin Blue's.

<sup>5</sup> McKinsey and Company (1995) *Growth Platforms for a Competitive Australia*, Melbourne, p118.

<sup>6</sup> Virgin Blue Press Release *Virgin Blue's Going Boeing \$5.4-Billion For up to 50 New Aircraft*, 16 January 2003.

<sup>7</sup> Virgin Blue Press Release *Virgin Blue Continues to Soar*, 15 May 2003

<sup>8</sup> Virgin Blue Press Release *Richard Branson Introduction Speech at the Press Conference in Adelaide*, 15 May 2003.

The Council appears to have accepted without any substantiation that low-cost airlines have low margins (6.145) – there is no evidence supporting this proposition in the Draft Recommendation. Clearly from the comments of Sir Richard, this is not the case. Sustainable low-cost airlines are able to offer lower fares because they have a lower cost structures and offer a product without add-ons (meals, frequent flyer programs etc) – it is about cost and market segmentation, not margins. That Virgin Blue is reporting stronger than expected profit growth, buying new aircraft and preparing for a float whilst Qantas is contracting services, cutting staff and issuing profit warnings is further evidence of relative margins.

All this casts the consideration of the competitive impacts of an increase in SACL's prices in an entirely different light. The question that needs to be asked is two-fold. The first is whether an increase in airport charges is likely to effect the competitive dynamic of the current duopoly. Given the evidence above on the impacts of airport pricing activity, increases in any feasible range are likely only to transfer small amounts of rent between SACL and the airlines, resulting in slightly lower margins for the airlines and slightly higher margins for SACL. And, to the extent that demand is relatively inelastic over short price ranges (say a dollar or so) airlines should be able to recover this without any significant loss in demand.

The more challenging question is how a price increase alters the conditions faced by potential new entrants. The first is one of materiality - how significant is the level of airport charges relative to other impediments such as the advantage the incumbents gain through scale and scope and rights over scarce infrastructure capacity. The second is SACL's own commercial response. If a new entrant were to emerge and SACL could accommodate it without significant infrastructure expenditure (which we understand to be the case, at least for the life of any potential declaration), then providing SACL believed the entrant would deliver SACL volume over and above that delivered to the incumbents, it would be profitable for it to provide assistance to the entrant that would enable entry. This form of effective price discrimination has been apparent for some time in the conduct of Australian airports in relation to international services and also by Melbourne and Sydney Airports (other others) when Impulse and Virgin Blue first entered.

### **Airline entry and airport pricing**

The basis on which airlines make decisions to add capacity is a critical issue to understanding how the structure of airport pricing may, if it does at all, effect final demand.

There seems to be some confusion on the part of Virgin Blue and its consultant as to how airlines make decisions about additional capacity. Virgin Blue (quoted by the Council at 6.134) says

Airlines make decisions about commencing on a route or increasing the number of flights on an existing route by comparing the incremental cost of that new route or flight compared with the estimated incremental revenue that could be generated from that new route or flight.

This is the correct view and reflects the experience in both domestic and international markets. The key decision making variable, the relevant increment, is the additional flight or route, not the marginal passenger. When allocating capacity, airlines make decisions about deploying aircraft, not seats.

Frontier Economics (quoted by the Council at 6.244) says in relation to passenger based charges

... charging per passenger increases the marginal costs to an airline of taking on an additional passenger. This increase in marginal costs will lead to inefficiently high prices for passenger services

Once an airline has scheduled a flight, the opportunity cost to filling the airline seat is very low ... this means that, in competitive markets, the pricing of marginal seats might be very low. By loading landing charges onto these marginal seats, airports would be raising the floor price on the price of the marginal seats offered by airlines.

Whilst this analysis has some simplistic appeal, it fails to address the relevant counterfactual. That is, if charges were not levied on a passenger basis, charges would be levied on a tonnage basis as preferred by Virgin Blue – a fixed charge per aircraft type. The effect of this is to raise the incremental cost of adding a new service relative to what it would be the case for passenger based charges – and according to Virgin Blue, this is the relevant cost to be considered.

The effect of tonnage based charges is to have airport charges as a fixed rather than variable costs. It is a generally accepted premise of basic microeconomics that the presence of fixed costs often constitutes a barrier to entry. Consider the case of two airlines operating identical aircraft but one is well established, with a large fleet and enjoys increasing economies of scale. The other is a new entrant trying to establish itself with a small fleet meaning its unit (and marginal) costs are much higher. The incumbent has brand loyalty, signed up commercial customers and operates with healthy load factors. The entrant is trying to get a foothold in the market and operates at relatively low load factors.

What is more likely to encourage competition – a situation where the level of charges is the same for each carrier under tonnage based charges or where the entrant pays less until its loads match those of the incumbents? The answer is obvious and if one accepts the general description of Ramsay pricing as “those who are prepared to pay more do” then it is also clear what pricing regime better reflects Ramsay prices. Further, it would seem passenger based charges come much closer than tonnage based charges to “charging low prices for marginal airlines and for marginal flights of established operators” – the condition Frontier Economics establishes for perfect price discrimination<sup>9</sup>

Given this, and the lack of any evidence that the introduction of passenger based charges has impeded the development of international services or indeed Virgin Blue’s business, it is reasonable to ask why Virgin Blue is so stridently opposed to SACL

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<sup>9</sup> Frontier Economics (2003a) *Sydney Airport declaration application: Report prepared for Gilbert + Tobin*, p24.

adopting what appears to be certainly a no less, and probably more, efficient pricing policy. It is simply that it will increase Virgin Blue's costs and transfer rent within the industry from Virgin Blue to Qantas. This is no doubt true as the general impact of a move to passenger based charges is to shift the relative charging burden towards users of smaller aircraft.

The Council correctly notes (6.127) that merely establishing that SACL may act in a way that damages Virgin Blues interests is not sufficient to conclude that declaration is warranted. The reason why Virgin Blue pays more under passenger based charges relative to tonnage based charges is because of the specific decision it has made in relation to the type of aircraft it operates – a point it seems to have conceded in submissions to the Council (see 6.250). It is entirely possible to conceive of a new entrant that may seek to operate on major routes, perhaps offering a two-class service and mimic Qantas' fleet by operating larger aircraft, say B767-300s. Such an operator would prefer passenger-based charges simply because it reduces its costs relative to the alternative – it is as much a function of fleet choice as it is incumbency or entry.

Melbourne Airport's experience is that the structure of prices makes no difference to competition between incumbents in either the domestic or international markets. When prices were increased and restructured on 1 July 2003, the average price per passenger (for the equivalent airside service) for a B737-800 (Virgin Blue's main aircraft) rose from \$1.88 to \$3.00 (excluding GST) whilst the price for a B767-300 (the main aircraft used by Qantas on major routes out of Melbourne) actually fell from \$3.14 to \$3.00. As noted above, since that change, Virgin Blue's share of capacity through Melbourne has increased from 22% to 34%<sup>10</sup>.

As outlined above, there is a rationale as to why passenger based pricing may provide benefits to entrants. In addition SACL (as quoted at 6.245) is correct in that passenger based charges provide better signals for efficient asset use. Irrespective of whether an airport is capacity constrained or not, its operations are more efficient (and delays less likely) the fewer aircraft movements it has to accommodate for a given volume of passengers. When these are taken together with the lack of any apparent impact from shift to passenger charges, the only conclusion one can reach is that the structure of charges does not materially impact on competition and therefore SACL's ability (however constrained) to change its pricing structure is not a matter that would warrant declaration.

Before leaving the issue of airport pricing structures, there are several other points requiring clarification.

It is simply not the case that Virgin Blue everywhere experiences more expensive access to terminals than its major competitor as suggested by Frontier Economics<sup>11</sup>. Qantas has to bear the full operating and capital costs of its terminals and pay rents and associated charges to airports that increase with volume. In relation to SACL, it should be clear that the marginal cost for Qantas to expand its existing capacity is greater than that Virgin Blue pays to use T2 otherwise Qantas would have expanded its existing facilities rather than enter into an access agreement with SACL to use T2. The relevant

<sup>10</sup> This assumes load factors of 75%.

<sup>11</sup> Frontier Economics (2003b). *Profit Maximising Monopoly Prices for the Airside Service*, Virgin Blue Application for Declaration of the Airside Service at Sydney Airport, June, p11.

question for competition is what is the price for the next major increment of domestic terminal capacity at Sydney Airport and how much greater will it be than the price both Virgin Blue and Qantas have negotiated for T2?

Related to this is the modelling by Frontier Economics that the Council has relied heavily upon. This modelling assumes that aeronautical revenues flowing from services other than the airside service are fixed. The bulk of these revenues will be charges for terminal use. As mentioned above, the revenues derived from the Qantas terminal are in part passenger related and we understand that a large part of the aeronautical revenues derived from T2 will depend on passenger volumes. The effect of making these changes must be to make SACL more sensitive to changes in volume and hence less likely to increase prices. This is a major flaw in the modelling by Frontier Economics that renders it in its current form unsuitable as a basis for decision making.

### **What is the appropriate price level for the airside service?**

It seems accepted that in May 2001 the ACCC did not object to SACL implementing a set of prices around competitive levels and that these prices that over the forecast period would remain around those levels and provide SACL to improve efficiency in its operating cost base<sup>12</sup>. Events since then, and in particular increases non-recoverable insurance and security costs and lower volumes mean that SACL's prices on a forward looking basis are probably now slightly below that which the ACCC would not object to on similar calculations.

In August 2002, the Supreme Court of Western Australia questioned whether the "competitive model" is the correct benchmark for considering prices charged by firms with significant market power<sup>13</sup>. The Council will no doubt be aware of this decision. Whilst the Supreme Court of Western Australia was dealing with the Dampier to Bunbury Pipeline under the Gas Code, the analysis is not sector specific and has general application, as both the Gas Code and Part IIIA have the Competition Principles Agreement as their genesis.

The judgement said

I am left with the clear impression that in the field of competition policy, especially market regulation, the prevailing view and using among economists is that a reference to a competitive market is that a reference to a workably competitive market. In the particular context of the promotion of a competitive market for natural gas it would be surprising if what was contemplated was a theoretical concept of perfect competition, as the subject matter involves very real-life commercial situations. Workable competition seems far more obviously to be what is contemplated. This is clearly consistent with the approach of the Hilmer Report.<sup>14</sup>

<sup>12</sup> For example Frontier Economics (2003b, p6)

<sup>13</sup> *Re Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd and Anor [2002]*, 23 August 2003, (the Epic Judgement).

<sup>14</sup> Epic Judgement, c124.

The Court went on to explain that a “workably competitive market may well tolerate a degree of market power, even over a prolonged period”<sup>15</sup> and that the objective to regulating tariffs is to “increase efficiency beyond that which could be achievable in a non-competitive market, although not necessarily achieving theoretically ideal efficiency”<sup>16</sup>.

The Court’s view is based is a complete view of efficiency – productive, allocative and dynamic, rather than a static one solely based on productive efficiency that gives rise to the notion of “competitive prices” arrived under the Optimised Depreciated Replacement Cost methodology used by Australian regulators (including the ACCC in its May 2001 decision in relation to SACL). The Court went on to recognise the persistence of prices over the competitive level may in some circumstances be in the public interest<sup>17</sup>.

Applying this logic to the case of SACL it is clear that the “competitive” level sets a floor on the range of prices that should be of concern and that under workable competition, one should expect prices in excess of that level, especially if SACL faces long-run increasing incremental costs. Moreover, declaration could only be justified if it was felt that SACL would price in a way inconsistent with the notion of workable competition. If, in the absence of declaration, SACL were to set prices at a level necessary to fund the ongoing operation of the business and provide the necessary investment to facilitate traffic growth in the future, and these prices were above competitive levels, this would not in itself constitute a case for declaration.

### **Government policy and industry conduct**

On 1 July 2002, as a result of the Government accepting the recommendations of the Productivity Commission, Melbourne, Perth, Brisbane, Adelaide, Canberra and Darwin Airports for the first time became subject to the same regulatory regime as SACL except for some minor issues relating to regional carriers<sup>18</sup>.

The Council will be aware of the intention of the Government (and its predecessor) that the provision of aeronautical and aeronautical related services should be on a normal commercial basis. The Government’s response to the Productivity Commission said “it was always the Government’s intention that airports and stakeholders should commercially negotiate pricing outcome on aeronautical and aeronautical related services”<sup>19</sup>. Significant changes in the provision of aeronautical services have occurred at most airports since July 2002; most of which include significant price increases, as a result of normal commercial negotiation. The arrangements at Melbourne Airport, and its conduct, have been recognised as world’s best practice by the International Air Transport Association through the awarding of its prestigious *Eagle Award*.

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<sup>15</sup> Epic Judgement, c128.

<sup>16</sup> Ibid.

<sup>17</sup> Epic Judgement, c130.

<sup>18</sup> The relevant instrument under the *Prices Surveillance Act 1983* is Direction 27. Issues relating to regional airlines using Sydney Airports are contained in Direction 28 and Declaration 90 under the same Act.

<sup>19</sup> Joint Press Release, Minister for Transport and Regional Services and the Treasurer, *Productivity Commission Report on Airport Price Regulation*, 13 May 2002.

It is understood that no major discussions have yet occurred at Sydney Airport. The reasons for this are clear and two fold. First, Sydney Airport does not yet have a Master Plan approved under the *Airports Act 1996* (and therefore not being certain of its capital program). Secondly, as a result of its later privatisation, its management has only just had the opportunity to review its operating cost base. Both of these issues must be resolved before any meaningful long-term agreement like those in place at Melbourne and Brisbane can be put in place.

Other than the material relating to the Productivity Commission's review and very recent research by Professor Forsyth, it is not clear what inquiries the Council has made relating to the intention of the Government in relation to its price monitoring policy.

During the early months of 2002 Melbourne Airport (and it is believed other airports) were involved in numerous discussions with officers of the Department of Transport and Regional Services, the Commonwealth Treasury and a range of Ministers and their advisors as to what sort of conduct would be acceptable under the new regime. The Government, no doubt having received very strong representations from airlines and tourist groups, was concerned that price increases (which were understood to be necessary given the poor returns on regulated assets) were kept to reasonable levels. It was clear to Melbourne Airport that seeking price increases of the order (in absolute and percentage terms) the ACCC had allowed SACL in May 2001 would not be acceptable. Further, Melbourne Airport was left in no doubt that the Government would act to deal with unacceptable conduct.

What has developed at major airports, and certainly Brisbane and Melbourne, are new commercial arrangements involving commitments to risk sharing, quality of service, capacity and consultation, in exchange for long term price paths that by 2007 may generate the sorts of returns that the ACCC allowed under the necessary new investment arrangements and had allowed SACL in May 2001. It is unambiguous that the Government's policy has restrained prices to below competitive levels in the medium term (five years).

At no point has the Council reflected on this experience. Nor does the Draft Recommendation reveal that the Council sought further advice from the Government on its policy intent. At a minimum, any recommendation to declare must contain further clarification of the Government's policy and why the behaviour of other major airports subject to the same regime (and in particular the same fear of re-regulation) and capital market pressures, is not a matter relevant to the consideration of Virgin Blue's current application.

There is no reason to believe that SACL understands the position of the Government in a different way to other major airports. Also, it is reasonable to assume that the airlines and ACCC are in a position to quickly identify if SACL is seeking to charge above competitive, or even workably competitively levels. It is naïve to believe (given previous conduct) that in the event of such an action by SACL, the airlines and the ACCC would not rapidly draw it to the attention of the Government - who if necessary could constrain SACL within hours using the *Price Surveillance Act 1983*. The airlines would also have restraints available to them via the courts.

As noted above, SACL is probably pricing at levels just below competitive levels. To achieve those competitive levels, SACL would need to increase prices by relatively small

amounts, and certainly by no means by as much (in percentage or dollar terms) as Melbourne increased its prices in July 2002. The upper limit of SACL's capacity to increase prices without attracting Government intervention is probably around 15%, possibly less. If greater increases were required to fund new capacity, the case could be made and would be consistent with a forward-looking approach and workable competition.

The Council has placed store in the Frontier Economics estimate that a doubling of the price of the airside service could see a resultant drop in demand of between 2-5% (6.205). Putting aside the problems with these calculations set out above, and assuming linearity, it would seem that the drop in demand that SACL could cause by raising its prices before the Government intervened is more like 0.3-0.7% - hardly material as is concluded at 6.207.

### ***The Public Interest***

Any assessment regarding public interest is inevitably subjective. It must in all but trivial cases involve a weighing up of apparent benefits and costs that often will not be amenable to objective measurement. Whilst accepting that the Council is not required to positively conclude that declaration would not be in the public interest, it must weigh the benefits of declaration against the cost and consider their relative strengths. It is unlikely that the position adopted in the Draft Recommendation at 10.61-10.63 of “because we can’t measure these things, we’ll conclude this criteria not met” was intention of the Parliament. Rather it was likely that because of the Council’s expertise in these matters, Parliament intended the Council to weigh the issues and form a view on these matters to assist the relevant Minister - otherwise there would be very little point to the Council’s existence.

As set out above, upon consideration of a broad range of publicly available market data, the case for declaration is significantly weaker than is made out in the Draft Recommendation. Similarly, there are reasons to believe that the costs associated with declaration are greater than concluded in the Draft Recommendation.

Melbourne Airport’s experience is that the time and costs associated encountered under the old regulatory arrangements (and extrapolation to what an arbitration might involve) are far greater than the costs recently incurred in reaching a sustainable five-year commercial settlement with airlines.

The Council also seems concerned at 10.55 that SACL may be able to extract monopoly rents from setting non-price access terms and conditions. The Council does not identify what these non-price terms and conditions may be or how they would affect competition. Presumably the attraction of declaration would be have these arbitrated by the ACCC along with the quantum of allowable revenue and the structure of prices. This would involve the ACCC in determining a much wider range of the parameters of supply than it would under a price cap (which would probably be limited to the starting prices, the value of X and the type of cap – tariff basket, unit revenue and so on). Each of these decisions involves the risk of error and it is likely that they are interdependent, thus further increasing the aggregate risk of error arising from the process. It is therefore difficult to see how the Council has concluded at 10.43 that the indirect costs (which largely flow from regulatory error) can be greater under a price cap than arbitration when the range of decisions is significantly less.

Whilst these issues are important, they are minor in relation to the local and economy wide impacts that declaration (and subsequent arbitration) might have. Investment lies at the heart of the public benefits test. As the Hilmer Committee noted

“... when considering the declaration of an access right to facilities, any assessments of the public interest would need to place special emphasis on the need to ensure access rights did not undermine the viability of long-term investment decisions, and hence risk deter future investment in important infrastructure projects.”<sup>20</sup>

<sup>20</sup> Independent Committee of Inquiry into Competition Policy in Australia (1993) *National Competition Policy: Report by the Independent Committee of Inquiry into Competition in Australia*, AGPS, Canberra, p251.

Investment issues fall into two broad categories –local costs of under investment and capital market impacts of declaration.

### **Local costs of under investment**

The Draft Recommendation shows that the Council is generally aware of ideas associated with costs of regulatory failure. Over time examples are beginning to emerge that show that when regulation does go wrong, it goes wrong in a catastrophic way - Railtrack in the UK and the Californian Electricity industry being the most spectacular.

There is a general, but not unanimous, view that regulators tend to err on constraining prices rather than ensuring future investment and as such, there is a bias in regulatory price setting (as would occur under arbitration) to set price below the appropriate (workably competitive) levels. However, even if one assumes that the errors in regulators' decisions are unbiased (they are as likely to allow excessive prices as they are to hold prices down below the right level) then there are good grounds to err on the side of not regulating when demand is highly inelastic.

Set out in the Appendix is an analysis (provided to the Productivity Commission) of the short and long run effects of regulatory over and underpricing when demand is inelastic. What it shows is that whilst in the short run welfare losses from over and underpricing are the same, in the long run the welfare losses associated from underpricing are much greater<sup>21</sup>. The reason for this is that in the long run underpricing removes investment incentives and consumer welfare losses result because capacity is insufficient to meet demand.

Applied to airports, if capacity is restricted, the ability of airlines to establish new services will be restricted and global experience has shows arrangements to handle finite capacity invariably favours incumbents. In other words, a direct consequence of regulatory under pricing is a reduction in competition – the precise thing declaration is supposed to encourage.

### **Capital market impacts of declaration**

As airlines are dependant on the services provided by SACL so is SACL dependant upon the capital market for the ongoing provision of capital to invest in the airside service, other aeronautical services and an ever increasing range of non-aeronautical services expected from a world class airport. Failure to deliver these services will unambiguously result in a loss of social welfare and possibly a reduction in competition, much in the way outline above.

The Council's analysis in chapter 10 seems to acknowledge that declaration would effectively involve setting aside the Government's previously stated policy without it being given the chance to operate. This will cause investors in SACL to increase SACL's cost of capital to compensate for additional regulatory risk if only because

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<sup>21</sup> Interestingly, it also shows that a profit maximising airport is likely to adopt a pricing policy that resembles that which would be expected under workable competition.

matters which previously they thought were with SACL's control would have effectively passed to the ACCC.

There is nothing in the Government's policy or the Council's Draft Recommendation to distinguish SACL from any other major Australian airport. Prudent investors would be entitled to conclude that every other major airport was subject to similar risk and as a consequence those airports would also experience an increase in their cost of capital. There is also a potential for second round effects as investors question the veracity of other areas of government policy that affect airports such as the administration of the *Airports Act 1996*.

The impact of an increase in the cost of capital is clear. Projects that previously would have proceeded will be delayed or not occur at all unless revenues increase. This can happen in only two ways – either volume must be higher or prices must be higher (thus defeating the purpose of controlling prices in the first place).

More likely is a situation where investment levels will simply be lower with investors seeking other avenues to deploy their funds. Welfare and competition losses will follow both in the aviation sector but more generally because of sub-optimal economy-wide resource allocation. But importantly, investment will be lower at Brisbane, Melbourne, Adelaide, Darwin and Canberra as well. This will create bottlenecks elsewhere in the network, which lead to costs to airlines through delay. It will also inhibit the ability of Melbourne and Brisbane in particular to invest in way to promote themselves as alternative primary entry points for international services.

The public interest in this matter extends beyond activities at Sydney Airport and the Council should consider the economy wide implications of declaration before making a final recommendation to the Minister.

## ***Appendix***

This is an extract from Melbourne Airport's submission to the Productivity Commission's Review of Price Regulation of Airport Services. It was prepared by Dr Warren Mundy (formerly of Melbourne Airport, now Director of Bluestone Consulting) and Dr Nicholas Gruen (Director of Lateral Economics)

### **The economic consequences of regulatory underpricing**

The analysis below draws on and extends a submission to the Productivity Commission's Review of National Access Arrangements on behalf of a large number of regulated businesses, including APAC<sup>22</sup>. The authors of the submission were NECG, the ACCC's consultants regarding the 'dual till' issue at Sydney Airport.

Given considerable uncertainty about what constitutes efficient costs, it will be rare for regulators to get the answer exactly right. In such circumstances it behoves policy makers to consider which kinds of mistakes they prefer. There are two kinds of mistakes a price regulator can make.

1. The regulator errs on the side of reducing monopoly rent. The risk here is that there is insufficient incentive to invest in infrastructure.
2. The regulator errs on the side of ensuring that sufficient incentives exist to provide adequate investment. The risk here is that monopoly rents are not fully squeezed out of airport pricing.

The first kind of mistake is more damaging to long term community welfare. There are several issues that should be distinguished. Firstly, other things being equal, the transfer of rent from one party to another has no efficiency implications. This is not to say that distributional issues are unimportant although it should be noted that the distribution here is between airline and airport shareholders and as such social equity considerations are likely to be minor.

Focusing on economic efficiency rather than distribution however, the economic costs and benefits between these approaches differ markedly between the long and the short term. NECG have contrasted the two situations by juxtaposing the two diagrams that follow. We believe that the NECG contribution is extremely valuable. However we argue here that it may even have underplayed its hand – that there are additional reasons for concern at the efficiency effects of regulatory underpricing.

#### ***The short run***

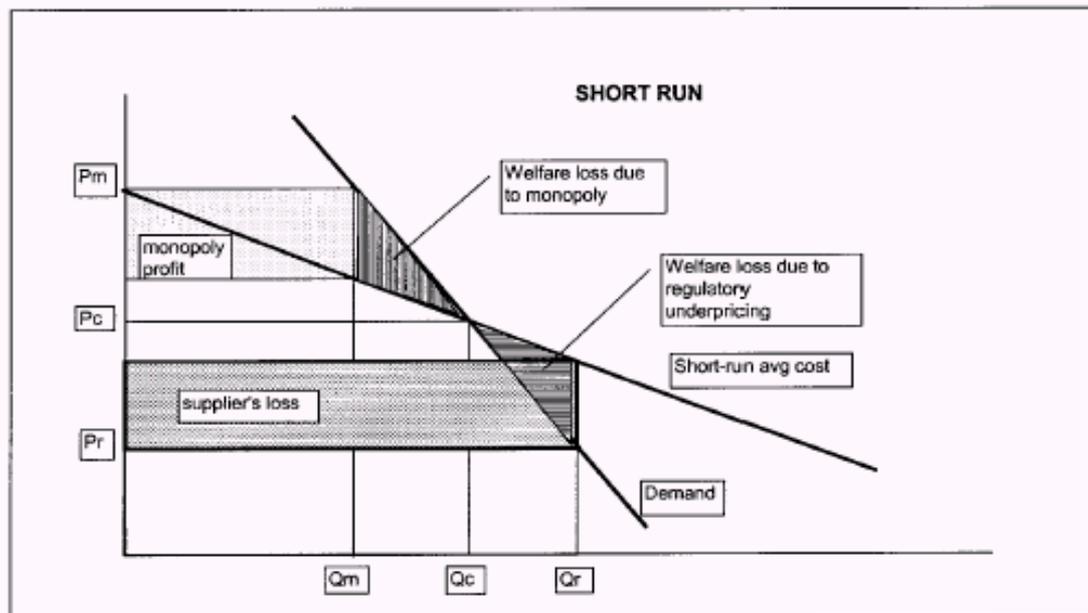
In the first diagram the short run demand and supply curves are represented by two downwardly sloping curves. The demand curve is steep reflecting low elasticity of demand. The supply curve is downwardly sloping – as is typical in the short run when as is often the case, infrastructure is not at capacity. Both curves are linear for simplicity.

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<sup>22</sup> NECG (2001) Submission to the Productivity Commission Inquiry into Part IIIA of the trade Practices Act.

Here monopoly pricing generates allocative inefficiencies – by constraining supply below its optimum. Likewise, allocative inefficiencies arise from regulating prices below their optimal level as some consumers consume resources that they value less than their cost of supply.

In this scenario, the welfare losses of both under and over-pricing are qualitatively symmetrical and, courtesy of the simplifying assumption of linearity, they are quantitatively symmetrical as well. The conclusions drawn here are not affected if instead, the short run average cost curve has an increasing slope.



In the above diagram  $P_c$  represents the competitive price level at which the supplier earns zero economic profit.  $P_m$  represents the monopolistic price, at which the supplier earns monopoly rents and there is a deadweight welfare loss to society equal to the area of the upper triangle (vertical hatching).

If instead the price is set at a level  $P_r$ , which is as far below  $P_c$  as  $P_m$  is above it, then clearly the supplier will make a loss in the short run. This loss is significantly greater in magnitude than the monopoly profit, which would have been made at  $P_m$ . (Note the supplier's loss is given by the rectangular area that partly overlaps the lower triangle.)

At  $P_r$  there is also a deadweight welfare loss, given by the area of the lower triangle (horizontal hatching). Under the assumptions used here, (i.e. linear demand and supply curves, and  $P_m - P_c = P_c - P_r$ ) this welfare loss is equal to the monopoly pricing welfare loss. In this case the welfare loss arises because some customers ( $Q_r - Q_c$ ) are supplied even though they value the service less than it costs to deliver – scarce resources are being diverted from the supply of services that customers value more highly.

In some ways this presentation is too balanced a picture of the short run. In fact, if we stick rigorously to *the short term* it is not clear that there is a loss in underpricing down to marginal or variable cost. Because the investment has already been sunk, then *in the short term* the only costs borne in servicing consumers are the variable costs and so, for simple theoretical reasons, if there were only a short term the optimal price would be marginal or variable cost.

But this is a world without time that is incapable of investing for the future. The kind of short-term gains involved are precisely the kind of short-term gains involved in other 'surprises' that are performed on economies either in theory or in practice – like lump sum taxes or unanticipated inflationary finance.

The short-term gains come precisely from traducing the implicit regulatory bargain with the investor that regulation will allow a commercial return for an efficient operator. The provider of the infrastructure now has a 'stranded asset'. The investor cannot meet its long run costs and so cannot fund proper investment in maintenance and/or expansion into the future. The party will soon over to be followed by a lengthy hangover.

### *The long-run*

In the long run, the welfare effects of overpricing versus underpricing are not symmetrical. Firstly, it is no longer true in the long run that a supplier would continue to provide service when the regulated price is below its average cost. In the long run, all costs are variable. Accordingly a regulated price that is below average cost would be below variable cost.<sup>23</sup>

Secondly, the long run average cost curve may, at the point it is intersected by the demand curve, have a declining, level, or increasing slope, notwithstanding the short run economies of scale of some assets.

If the long run average cost curve were downward sloping or flat (as may be the case with airports with large amounts of surplus capacity), then the consequences of a regulated price which is below the equilibrium level would be very serious from a welfare perspective. There would be no level of output greater than zero at which the supplier could recover its long run variable costs (equal to long run average costs). Faced with this situation, the supplier would either exit the industry when reinvestment was required, or would attempt to modify its long run average cost curve by degrading service quality or investing in assets with low capital cost and high operating costs. If the output level is reduced to zero, then the welfare losses will be maximised.<sup>24</sup>

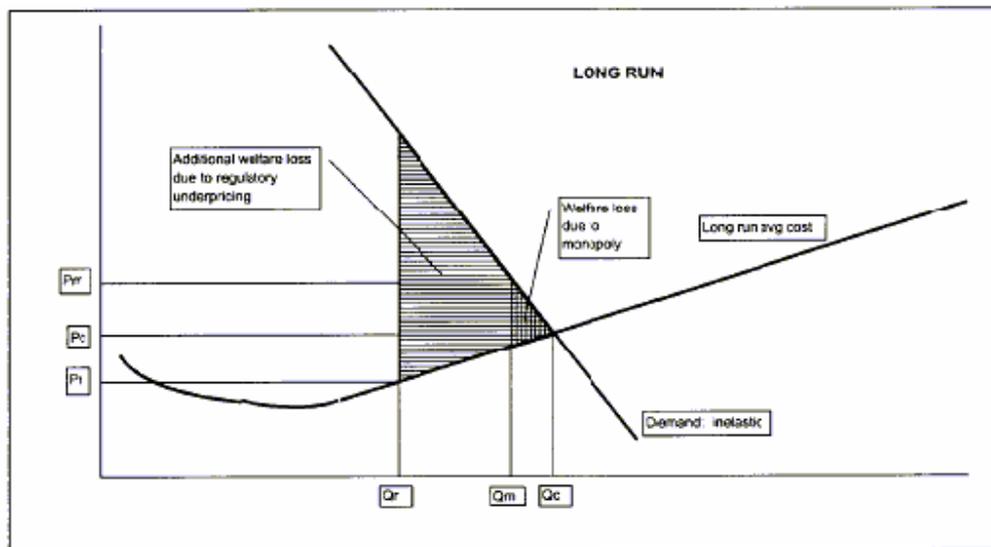
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<sup>23</sup> In practical terms, a supplier faced with a regulated price below average cost may not exit the industry immediately. Some alternatives include declining to invest in asset renewals when required, allowing service quality to degrade, or investing in new assets with lower capital cost but higher operating and overall life-cycle costs. Both intuition and recent experience suggests that the welfare losses associated with such conduct are likely to be substantial. Indeed this follows from any acceptance that the facilities in question are essential facilities of national significance.

<sup>24</sup> Note here that while the diagram depicts the demand curve as downwardly sloping and linear, the 'law' of diminishing returns suggests that, near the origin the curve would most likely rise very steeply indeed. The last few customers left unsatisfied in the market for essential services would value those services very highly indeed.

Accordingly to produce any output from the supplier in the long run the familiar, though probably less realistic, assumption must be made – that the long run average cost curve is upward sloping. In these circumstances, the supplier continues to operate into the long run, but at a lower level of output than competitive equilibrium level by an amount needed to align long run average costs with the regulated price.

This situation is depicted in the diagram below. In this diagram, as in the short run diagram, the demand curve is steep reflecting the low elasticity of demand for aeronautical services. In contrast, the slope of the supply curve is gentle. Accordingly, supply must be wound back substantially before supply cost falls to a level consistent with the regulated price.



Relative to the competitive equilibrium price,  $P_c$ , monopolistic pricing  $P_m$  would lead to a welfare loss equal to the area of the smaller triangle with cross-hatching. However this welfare loss is small compared to the loss arising from underpricing  $P_r$ , which is as far from  $P_c$  as is  $P_m$ . The welfare loss due to  $P_r$  is given by the large triangle (which overlaps the small triangle). The net welfare loss relative to monopoly pricing is equal to the horizontally hatched trapezoid.

Thus in the long run, for a pricing error of a given magnitude, the welfare loss will be significantly greater if the error is in pricing too low rather than too high. This conclusion holds wherever the demand schedule is steeper than the supply schedule, a situation that would seem very likely with services subject to declaration.

As has been noted above, the welfare losses associated with low prices are not immediately apparent, in contrast to the short-term transfers enjoyed by consumers. Nevertheless, economic analysis suggests that these future welfare losses are likely to be extremely high.

This conclusion is surely consistent with every-day experience. When under-investment leads to poor quality of service or unreliable supply, the flow on effects to other businesses and the economy broadly are often extremely serious. One only has to remember instances in the past twenty years of blackouts and brownouts, gas supply

disruptions, train derailments, or water contamination incidents to appreciate the severe consequences of service interruptions. The breakdown of infrastructure can be particularly costly, because users have got into the habit of relying on it and have not developed the kinds of backup systems, which they would have done if the infrastructure were not there.

Again, it is possible to contrast the optimism of the short run with pessimism about the long run even more strongly than the NECG's illustrations do. For the cost of policy opportunism towards the owner of sunk infrastructure investments is not just the under-provision of services into the future as a result of sub-optimal returns on yesterday's investment.

Perhaps even more seriously, regulatory opportunism also degrades the capacity of investors to rely on the integrity of the regulatory structure into the future. We have argued elsewhere that the ACCC does not pay sufficient attention to the sovereign risk issues that arise from its regulatory decision making processes<sup>25</sup>. After all, the investor has invested in good faith believing that provided they are efficient, they can earn a commercial return on funds. When the regulator has bitten once, investors can be expected to be twice shy. To attract investment into the future, the very thing which regulation seeks to prevent may become necessary. Sustained supernormal profits for a monopoly investor.

There is also a political dimension to these matters. Erring on the side of overzealousness about monopoly rents will also be politically popular as taking advantage of the investor's sunk costs creates a 'free lunch' in the short term. Again the parallel can be drawn with opportunistic economic policies in other areas. Unanticipated inflationary policies will often be popular, until the full costs emerge over time. When they do, repairing the damage is all the more difficult because of the damage done to policy credibility in the meantime.

### **Optimal pricing outcomes err on the side of investment**

In the short term and at the margin, it would be possible for airports to increase some of their prices – principally relating to their core landing and passenger services. Indeed they could do so substantially.

If they did so, only minor damage would be done to economic efficiency. The economic significance of the price change would mostly amount to a transfer of economic rent from airport customers – in this case airlines – to airports.

In addition to the potent threat of regulation, there are strong theoretical reasons for believing that, given their cost structure and the market opportunities available, airports' long-term interests are better served by seeking to grow their businesses. This will lead them to forsake opportunities to capture short-term economic rents. As an empirical matter, this is Melbourne Airport's long term business plan – to grow its businesses by aggressively serving markets with high quality airport services at competitive prices. It is the pursuit of this policy that encourages the entry and development of airline services

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<sup>25</sup> Australia Pacific Airports Corporation (2001) *Submission in Response to the Draft Decision of the ACCC relating to the Aeronautical Pricing Proposal of Sydney Airports Corporation Limited*, Melbourne, February.

Price regulators will always have imperfect knowledge. Furthermore, the long-term efficiency consequences of regulating prices below their optimal level can be very grave. By contrast long term prices modestly above the competitive optimum involve low economic efficiency losses. It follows that, should price regulation be considered necessary for whatever reason, it is important for price regulators to avoid imposing underpricing on airports. They should, if necessary, tolerate the possibility of erring slightly on the side of pricing above the competitive optimum.

Such a pricing approach would be consistent with the sort of business conduct that would arise from Melbourne Airport's general approach; an approach that is likely to maximise profit for most uncongested airports. We would argue similarly that if the Commission was to form the view that such a pricing approach is the optimal one from the airport's point of view, and that the chances of regulatory error exist, then no regulation may well lead to the most efficient outcome as it is likely to get closer to efficient prices than would be set by the regulator.

This argument may be represented in the following diagram. Here the long-run profitability of the asset is mapped against price. Profitability exhibits both a local and a global optimum. By definition, the profit maximising price for an asset with some degree of natural monopoly is above the price that would be charged in a competitive environment ( $P_c$ ).<sup>26</sup> If it were not, there would be no natural monopoly. Nevertheless, the nature of the asset's cost structure is such that there exist two profit optima. One is motivated by exploiting the monopoly by raising price to  $P_{M2}$ . The other focuses on growth mindful of the proportion of the asset's costs that are fixed, and accordingly the extent to which increased activity can lower average costs. This growth oriented monopoly price,  $P_{M2}$ , the global monopoly optimum for the asset is not far above the socially optimum price. It is also approximately the price at which a regulator properly concerned with long run efficiency rather than short-term price control would regulate prices.

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<sup>26</sup> Note however that even this language is paradoxical. The very phenomena which give rise to natural monopoly – that is economies of scale – also make perfect competition with its many competitors inefficient.

