**Sydney Airports Corporation Limited**

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Mr Graeme Samuel, AO
President
National Competition Council
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Attention: Ms Deborah Cope, Acting Executive Director

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Dear Mr Samuel

## Application by Virgin Blue for Declaration of Airside Services at Sydney Airport

Sydney Airports Corporation Limited (SACL) is pleased to provide this submission to the National Competition Council in relation to its assessment of the application by Virgin Blue for declared access of certain Sydney Airport facilities, pursuant to Part IIIA of the *Trade Practices Act 1974*.

SACL considers that declaration of airside facilities at Sydney Airport is not warranted, primarily because it would not promote competition in the domestic aviation market, and because it would be unnecessary and inconsistent with public policy and the public interest, in light of the Government's decision to deregulate airport pricing. SACL's response to the points raised by the Virgin Blue application and the NCC's issues paper follows.

### Background

For the reasons detailed below, SACL's objective is to maximise air traffic and passenger numbers through Sydney Airport, and to this end it actively encourages and supports the operations and growth of existing and new carriers. This is particularly the case with Virgin Blue, as SACL recognises the importance of a competitive and dynamic domestic aviation environment.

Virgin Blue has been using Sydney Airport facilities since 31 August 2000 and SACL has actively facilitated Virgin Blue's operations. In response to the difficulties previously encountered by start-up airlines in gaining access to incumbent airlines' terminals, Sydney Airport constructed a common-user terminal specifically for Virgin Blue and the other new entrant at the time, Impulse. This terminal, known as the Domestic Express Terminal, accommodated Virgin Blue's operations until it recently moved its operations to the former Ansett terminal.

Following the collapse of Ansett Airlines in September 2001, SACL took advantage of the opportunity to acquire the failed airline's terminal at Sydney Airport. This provided a valuable opportunity to make available a high-quality common user terminal at the airport, for domestic and regional operations. SACL took control of this terminal from 1 July 2002 and subsequently renamed it Terminal 2.

This represented a breakthrough in domestic aviation as the major domestic terminal assets around Australia, including Sydney, had been locked up under long-term leases to the two incumbent airlines.

The origins of Virgin Blue's application for declaration of airport services lay in negotiations between Virgin Blue and Sydney Airport last year over the terms of use of space in Terminal 2. As Virgin Blue notes in its application, it considered that it had an agreement with Sydney Airport for terminal use, with the alleged agreement based on dedicated use of one pier of the terminal. A subsequent Commonwealth Government review concluded that a binding agreement did not exist.

SACL's motivating concern in its negotiations with Virgin Blue was to avoid perpetuating the access difficulties previously encountered under the domestic terminal leases to the two incumbent airlines, as would have occurred if Virgin Blue had been granted exclusive rights to a significant portion of the newly acquired terminal. SACL wished to maintain the terminal as a predominantly common-user facility, to avoid exactly the difficulties that had been encountered by Virgin Blue and Impulse in their start-up phases. The Australian Competition and Consumer Commission (ACCC) endorsed SACL's attempts to retain sufficient flexibility to accommodate potential new market entrants or changes in the composition of the domestic aviation market.

Virgin Blue now uses Terminal 2 under commercially agreed, pro-competitive terms. When use of the terminal was agreed, Virgin Blue withdrew its Part IIIA application in so far as it related to the terminal, but has continued its application for declaration of other airside services at Sydney Airport. In doing so, Virgin Blue has stated that it "seeks declaration ... to ensure that in the event that SACL seeks to impose unreasonable charges upon it, Virgin Blue may dispute those charges and have that dispute determined by the Commission".

**Framework for Use of Sydney Airport by Airlines**

Prior to considering specific elements of the Virgin Blue application, it is appropriate to briefly consider the framework under which airlines use Sydney Airport facilities.

Use of Sydney Airport is primarily controlled by the *Sydney Airport Demand Management Act 1997*, under which a "Slot Manager", independent of SACL, called Airport Coordination Australia (ACA) manages use of the airport through allocation of slots for landing and taking off. Each season, of which there are two a year, ACA assesses slot availability and allocates slots according to requests lodged by airlines. Airlines holding slots are able to maintain these across seasons based on closely defined 'grandfathering' rights.

Under the slot regime, a 'regional ring fence' protects around one third of peak hour slots for use by regional (intrastate) services; and an overall limit of 80 movements an hour applies at the airport. Use of the airport is further affected by a jet movement curfew between 2300 and 0600 hours and by the government policy of noise sharing across Sydney known as the Long Term Operating Plan.

SACL is also required under the terms of its airport lease from the Commonwealth to provide access to the airport for intrastate, interstate and international air transport services. We also have obligations under the facilitation guidelines promulgated by International Civil Aviation Organisation (ICAO).

Airlines holding a slot right then use the airport under the terms and conditions of the Sydney Airport Conditions of Use, which sets out a contractual and administrative framework for using airport facilities.

Airport charges specified in the Conditions of Use were approved in May 2001 by the ACCC under the pricing regime then in place pursuant to the *Prices Surveillance Act 1983*, following an extensive period of industry consultation. These charges were set at levels intended to cover SACL's reasonable operating expenses and to provide SACL with a fair return on its assets. Changes to these charges for the recovery of new capital investment are made with the agreement of airlines after consultation with an airline committee.

On 13 May 2002, the Commonwealth Government announced that it would deregulate aeronautical charges at Australia's major airports, including Sydney, from 1 July 2002. This is for a five year probationary period, with the pricing behaviour of airports subject to ongoing scrutiny through price monitoring and to the threat of re-regulation at any time prior to or after the end of the five year period, in the event of misuse of market power. The Government's decision was based on the recommendations of the Productivity Commission, which concluded that the pricing behaviour of airports for aeronautical services was subject to sufficient controls and incentives not to warrant formal regulation.

**Assessment of the Application Against the Trade Practices Act Criteria**

The Virgin Blue application fails to make a case for declaration under Part IIIA of the Trade Practices Act by reference to at least two criteria:

- that access or increased access to the services would promote competition in at least one market other than the market for the service - section 44G(2)(a); and
- that access or increased access to the service would not be contrary to the public interest – section 44G(2)(f).

These are each discussed below.

Promotion of Competition in at Least One Market

SACL agrees with Virgin Blue's approach that the relevant market for the purposes of the Virgin Blue application is the market for air services within Australia to and from Sydney.

A point of difference, however, is that Virgin Blue considers interstate and intrastate services together, whereas SACL is of the view that they should be considered as separate markets because of the particular regulatory protections that are offered to regional services at Sydney. The relevant markets then, in SACL's view, are the two markets for domestic (interstate) and regional (intrastate) air services to or from Sydney.

SACL can see little benefit in the NCC's suggestion that a more narrow definition of the market might be appropriate. While the market for domestic (interstate) services could theoretically be split into market segments such as city pair, business/leisure passengers, such segregation is of more relevance to an airline in its operations than to the use of an airport by aircraft. SACL does not differentiate between domestic services based on origin or destination, nor on the type of passenger catered for by the service. Accordingly, SACL suggests that an attempt to further disaggregate the logical market definitions of domestic and regional services would increase the complexity of assessment of the application without yielding practical benefits.

*The Domestic Market*

Competition in the market for domestic services would not be enhanced by declaration of Sydney Airport facilities.

Because access to the airport is governed by the slot regime, at the heart of the Virgin Blue application is whether monopoly power might be misused by Sydney Airport in setting the terms of access, and in particular, price.

The NCC's issues paper makes the important point that, to warrant declaration, an airport must have not only the ability to misuse monopoly power, but the *incentive* to do so. While runways and taxiways clearly possess natural monopoly characteristics, as noted by the Productivity Commission, airports do not have any incentive whatsoever to restrict access to airport facilities or to constrain throughput.

Airport services are not vertically integrated and SACL therefore has no incentive to restrict use of the airport to promote the interests of specific upstream or downstream markets. Further to this, SACL has an active and strong incentive to increase aircraft and passenger throughput because this maximises not only aeronautical revenue but also consequential non-aeronautical earnings from retail sales and car parking. In this regard, SACL notes that in 2001-02, its aeronautical revenues were $180 million, compared with $246 million from non-aeronautical activities. Indeed, this strong incentive to promote throughput was a significant factor in the Productivity Commission's conclusion that a probationary period of price deregulation was appropriate.

Accordingly, while SACL may have the capacity to change terms and conditions for Virgin Blue in a way that may detrimentally affect its position relative to competitors in the same market, it does not have an incentive to do so. Changing terms and conditions to disadvantage Virgin Blue would in all likelihood reduce SACL's total aeronautical earnings, and would not optimise associated non-aeronautical charges. SACL's strongest incentive is to promote healthy competition in the markets for flights to and from Sydney and, in doing so, optimise aeronautical and non-aeronautical revenues.

Virgin Blue has not pointed to any sound basis to suggest that SACL has any incentive to act to Virgin Blue's detriment in setting terms and conditions for aeronautical services. Virgin Blue's application cannot succeed simply on the basis of potential capacity for SACL to act in this way; it is necessary that incentive be demonstrated. Were it otherwise, the elaborate declaration processes of Part IIIA would be unnecessary and the Government would have chosen to perpetuate the regime under section 192 of the *Airports Act 1996*.

Virgin Blue's reference to SACL's original application to increase its aeronautical charges by an amount in excess of that eventually allowed by the ACCC does not provide evidence of an incentive for SACL to increase its charges, or any incentive to do so.

SACL's notification to the ACCC for a proposed increase in aeronautical charges was intended to move SACL's charges from the network-based regime inherited from the former Federal Airports Corporation to charges that were location-specific and appropriate for a stand-alone business to earn a fair return on its assets.

SACL's submission to the ACCC was based on a widely accepted economic framework for establishing prices for infrastructure assets. Indeed, a substantially similar framework was applied by the National Competition Council in reaching its November 2002 decision not to recommend revocation of coverage for the Moomba to Sydney Pipeline system. While

SACL was of the view, following extensive consultation with airport users, that its proposed prices were soundly based and justified by reasonable operating costs and fair asset valuations, the ACCC took an alternative view in relation to a small number of key matters. Most significant was the method of valuing airport land.

Although having a difference of opinion on a number of aspects of the ACCC pricing decision, SACL accept the judgement of the ACCC, even though this delivered charges lower than had been proposed. Evidence of this is SACL's pricing behaviour since deregulation on 1 July 2002, with SACL not having made any substantive increases in charges. Price adjustments, of several cents, since that date have reflected the outcome of a process for financing new capital works, endorsed by airline users in a consultative committee that includes Virgin Blue.

SACL is considering moving its domestic aeronautical charges from a maximum take-off weight basis to a per-passenger basis. It is committed to consulting with carriers to explore possible charging structures, levels and terms and conditions that will not generate adverse impacts on carriers. This is because, as noted above, its strong incentive is to avoid any change to its aeronautical charges that would adversely impact competition in the market for flights to and from Sydney and thereby passenger throughput numbers.

*Regional Services Market*

SACL submits that regional services do not warrant any further consideration under this application because of the specific regulatory protections available to them. These services are subject to a 'regional ring fence' under the Sydney Airport slot management regime that protects access to the airport through slot rights. More significantly for the purposes of this application, aeronautical charges for regional services continue to be price controlled under the *Prices Surveillance Act 1983*, with charges not able to increase annually by more than the rate of inflation. Bearing in mind these controls, competition in the market for regional services would clearly not be enhanced by declaration of relevant airport services.

Declared Access Contrary to the Public Interest

SACL is firmly of the view that a decision to declare access to Sydney Airport facilities at this time would be contrary to the public interest.

The Government decided last year to deregulate aeronautical charges at Australia's major airports, including Sydney, for a probationary period of five years starting from 1 July 2002. This decision accepted the recommendations of the Productivity Commission which stated, in its Report of Price Regulation of Airports, that the public good would be best served by price deregulation. The Government is to monitor airport pricing behaviour (through the ACCC) and will review performance no later than the end of the five year period. It will then assess the appropriate form of any ongoing price regulation. The Government reserves the right to reintroduce price controls during the course of the five year period if warranted.

The Productivity Commission concluded that airports did not need to be regulated to control monopoly pricing by airports, because of the:

- strong incentive that airports have to maximise air traffic and passengers and thereby maximise aeronautical and consequential non-aeronautical revenue;
- countervailing power of airlines;
- potential for declaration under Part IIIA; and
- threat of re-regulation.

The Productivity Commission believed that deregulation would lead to better overall economic outcomes, in particular because of:

- reduced administrative costs to airports and the regulator;
- reduced regulatory costs, notably the effect of regulatory uncertainty on new investment and the unproductive activity of regulatory gaming.

Sydney Airport acknowledges that the access regime under Part IIIA of the *Trade Practices Act* is an important safeguard against misuse of market power, and was recognised as such by the Government in its decision to deregulate charges.

However, SACL notes the absence of any incentive or likelihood of a use of market power of a type that would give rise to a dispute warranting ACCC arbitration. The Government has set out criteria for the assessment of airport behaviour under deregulation, and the threat of the reintroduction of the burdens of regulation provide a significant incentive not to misuse market power. In seeking recourse to this regulatory safeguard so early in the probationary period of deregulation, Virgin Blue's proposal for declaration is inconsistent with the spirit of the Government's public policy.

As noted above, Virgin Blue has stated in its application that it is concerned about the potential pricing behaviour of Sydney Airport and wishes to have declaration of the facilities in place as a safeguard. Had the Government intended that all airport charging decisions be subject to ACCC arbitration, clearly it would not have chosen to deregulate airport charges. It would instead have persisted with and sought to expand the access regime formerly provided under section 192 of the *Airports Act 1996*. The access regime under Part IIIA is intended to allow for intervention where the ability and incentive for misuse of monopoly power warrants such action. The mere *potential* for misuse of market power does not in itself warrant price intervention, absent of incentive.

Sydney Airport's current charges were established under the regulated environment to provide a fair return on its aeronautical assets and reasonable operating costs, and the airport has demonstrated a responsible use of market power in its pricing behaviour since deregulation. Sydney is the only major airport not to have changed its charges substantively since price deregulation.

In summary, declaration of Sydney Airport facilities at this time would be inconsistent with the Government's public policy intent of price deregulation. In the absence of any incentive for misuse of market power at Sydney Airport, it would be inappropriate to invoke the regulatory safeguards, and thereby deny SACL, airport users, and the community the benefits expected to be derived from price deregulation, including reduced administrative costs and better investment decisions under relative regulatory certainty.

**Response to NCC Requests to Specific Issues**

Scope of the Application

Virgin Blue has sought declaration of the airside service, which it defines as "a service for the use of runways, taxiways, parking aprons and other associated facilities necessary to allow aircraft carrying domestic passengers to take-off and land using the runways at Sydney Airport; and move between the runways and the passenger terminals at Sydney Airport".

The NCC has requested input as to the minimum bundle of services required to use Sydney Airport. This is relevant in considering a number of aspects of the application:

- whether the minimum bundle is the 'whole of the airport' as found in the Sydney Airport case;
- the scope of "other associated facilities" referred to in the Virgin Blue application; and
- whether the assessment should properly include freight services, as suggested by the NCC in its issues paper.

SACL does not believe that the application, nor the nature of airport facilities, supports the conclusion that the minimum bundle of airport services is the whole of Sydney Airport. While this conclusion was reached by the Australian Competition Tribunal in the ACTO case, we do not consider it to be the appropriate conclusion in the case of the Virgin Blue application. SACL acknowledges that runways and taxiways display strong natural monopoly characteristics. They are expensive assets requiring large tracts of land and could not be economically duplicated. We note, however, that any decision to construct a second Sydney Airport may change this conclusion.

In terms of aircraft parking aprons and terminal facilities, however, substitutes exist. An airline can choose, economically, to develop its own aprons on leased airport land and similarly could do so for terminal facilities. Precedents exist for an airline developing aprons and terminals. The former Ansett leased stand-off aprons developed specifically for its use. Both Ansett and Qantas developed their own terminal facilities at the airport. In addition, the construction of the Domestic Express Terminal was undertaken at very low cost and demonstrates that a quality, workable terminal facility can be economically developed by an airline if it chose to do so. There is not a real shortage of airport land for development of terminal facilities, with the recently purchased 'Northern Lands' and 'Pacific Power' sites offering ample space contiguous to the airport. Further to this, SACL notes that the Qantas domestic terminal offers a potential substitute for terminal and apron facilities provided by SACL.

Development of additional apron or terminal facilities by a carrier could not be considered to be uneconomical in terms of the overall allocation of resources. The economies of scale associated with such terminals are not of sufficient magnitude to imply that it would always be cheaper to have a single facility rather than two or more.

SACL considers that use of the term 'other associated facilities' is far too broad and is likely to lead to confusion and dispute over the types of facilities covered by the application. It is essential that the terms of any declaration that may be made should allow no room for subsequent debate as to the extent of, or limitations on, the resultant jurisdiction of the ACCC in the event of an access dispute. SACL is happy to assist in defining the types of facilities required for use of the airport by relevant airlines.

The NCC has noted in its issues paper that freight facilities ought to be considered as part of the application, as freight is commonly carried in the hold of passenger aircraft. SACL does not support the inclusion of freight facilities, noting that the Virgin Blue application is limited to those facilities required to allow "aircraft carrying domestic passengers". While many such aircraft carry freight also, this is incidental to their role of carrying passengers and does not require dedicated freight handling facilities of the nature used by freight-only carriers.

Further, the Productivity Commission concluded, in its report on Price Regulation of Airport Services, that airports held relatively little market power in the provision of freight services, with freight facilities able to be located off-airport or readily duplicated using leased airport land. SACL notes that, apart from a common-user freight facility at Sydney Airport that SACL operates, a number of organisations operate their own on-airport facilities, including Patrick Corporation, a substantial shareholder in Virgin Blue. For these reasons, were the NCC to give consideration to the Virgin Blue application, SACL recommends that freight facilities not be included within the scope of the Virgin Blue application.

Airline Countervailing Power

The issues paper also sought comment on the effectiveness of airline countervailing power as a protection against misuse of market power. Despite the relative size of Sydney Airport, airlines have demonstrated the strength of their countervailing power on a number of occasions.

The fact that airports require sustained levels of traffic and passenger throughput in order to maintain not only their aeronautical revenue streams but also their non-aeronautical revenues clearly gives airlines a significant degree of countervailing power. The airport/airline relationship is not one of monopoly vendor and powerless purchaser. The close interdependence between the two, particularly in the case of major interstate carriers, means that the relationship is far more closely balanced and that the scope for misuse of market power by an airport is greatly dissipated, if not negated.

Indeed, the actions of Virgin Blue during the negotiations for its use of Terminal 2 are a strong demonstration of effective countervailing power. The airline not only initiated legal action in relation to an alleged commercial agreement, it also lodged an application for access under Part IIIA and undertook a robust and targeted publicity campaign against the airport and its major shareholders. This dispute was also able to be resolved commercially.

**Conclusion**

Virgin Blue's application for declared access to Sydney Airport airside facilities fails to meet the criteria set down by the Trade Practices Act because declaration:

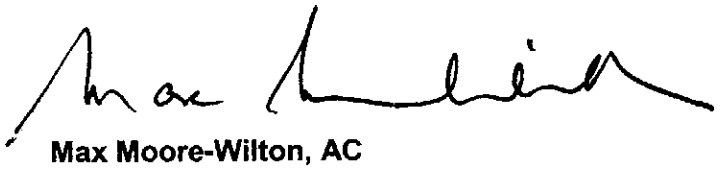
- would not promote competition in the market for domestic air travel, because Sydney Airport does not have any incentive to misuse market power, and
- would be contrary to the public interest as it would inappropriately displace the regime of price deregulation, deliberately and recently implemented by the Commonwealth Government.

Virgin Blue has sought to reintroduce price regulation through the access provisions of the *Trade Practices Act*, denying the community the public benefits expected to flow from the price deregulated airport environment.

SACL considers that the public interest would be best served by allowing the probationary period of price deregulation to run its course unless there is a demonstrated misuse of market power or a clear apprehension that such is imminent. Virgin Blue has failed to demonstrate either of these preconditions because it has not been able to point to any incentive on SACL's part to alter price or other terms and conditions in a way that would be inimical to competition in any market.

The Part IIIA provisions, along with the threat of more direct price regulation such as that formerly in place under the *Prices Surveillance Act 1983,* will continue to represent an important safeguard for airport users, as will the incentive for airports to maximise traffic and the countervailing power of airlines.

Yours sincerely



**Max Moore-Wilton, AC**
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