Economic regulation of airport services

Submission by the Virgin Australia Group on the Productivity Commission Draft Report

PUBLIC

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1. Executive Summary

Virgin Australia remains firmly of the view that major airports are natural monopolies, and that the current regulatory regime does not provide an effective constraint on their ability to exploit this position to the detriment of the community.

We are therefore disappointed with several aspects of the Commission's draft report in its inquiry into the economic regulation of airports (**Draft Report**). We consider that the Draft Report grossly overstates the extent to which the market power of airports is constrained by the countervailing power of airlines. We also consider that the Commission has overstated the risks and costs associated with greater regulatory oversight, and underestimated the economic costs associated with the continuation of an ineffective monitoring regime.

Virgin Australia supports the submissions made by Airlines for Australia and New Zealand (**A4ANZ**) in response to the Draft Report. In this submission we provide additional comments, case studies and evidence, drawn from our experience in dealing with airports.

Airports' ability to exercise market power

Virgin Australia strongly disagrees with the Commission's conclusion that airports are unable to exercise their market power in commercial negotiations to the detriment of the community.

In this submission, we provide further examples of where airports have behaved in an entirely unconstrained manner in negotiations with Virgin Australia. This includes making "take-it-or-leave-it" offers, withholding critical information, requiring Virgin Australia to bear a disproportionate share of relationship risk, and seeking to foreclose access to regulatory remedies.

We also provide evidence in this submission to refute a key claim made in the Draft Report – that airlines are able to gain leverage in negotiations by threatening withdrawal of services from an airport. For a full service airline such as Virgin Australia, which needs to maintain a network of routes and destinations, any threat of withdrawal from a major airport will simply not be credible.

Markets for jet fuel

Virgin Australia agrees with the key findings in the Draft Report, in relation to restrictions on competition in markets for jet fuel. As the Commission correctly observes, these restrictions on competition arise principally due to conflicts of interest associated with infrastructure ownership, and a lack of open access arrangements.

Virgin Australia supports the recommendation for open access to jet fuel infrastructure at the new Western Sydney Airport, and we consider that similar recommendations should be made in respect of jet fuel infrastructure at existing airports. It is not clear why the same remedy should not apply at existing airports, given the structural barriers to competition identified by the Commission.

Reform directions

Virgin Australia is concerned that the Commission's recommendations for further and enhanced monitoring of airports' performance do not go nearly far enough. Continued ACCC monitoring and the prospect of another Commission inquiry in 2024 will not provide any meaningful constraint on airports' market power.

Virgin Australia continues to support A4ANZ's proposal for an industry-specific negotiate-arbitrate regime. We consider this to be the most practical solution available to constrain airports' ability to exercise market power.

We consider that the Commission's concerns with the proposed industry-specific regime are misplaced. The proposed negotiate-arbitrate regime represents a limited and proportionate response to the problem of airports exercising market power. We consider that the costs and risks associated with this limited form of regulatory oversight are likely to be small, particularly when compared to the very significant economic costs associated with ongoing exploitation of market power by major airports.

2. Airports' Market Power

This section addresses the key findings and recommendations in sections 3, 4 and 5 of the Draft Report. These relate to the market power of airports, the extent to which airports are able to exercise this market power, and implications of this for their performance and negotiations with airlines.

In summary:

- Virgin Australia agrees that the four monitored airports have market power in aeronautical services – indeed, we consider these airports to be natural monopolies.
- However, we consider that market power is not limited to the four monitored airports. Other major capital city and regional airports also have market power.
- Virgin Australia strongly disagrees with the Commission's conclusions regarding the extent to which airports are able to exercise their market power in commercial negotiations to the detriment of the community. These conclusions run contrary to our experience in commercial negotiations with airports, as described below and in our initial submission.

Each of these points is discussed below, with reference to further information and evidence as requested in the Draft Report.

2.1 Market power findings

DRAFT FINDING 5.1

The four monitored airports — Sydney, Melbourne, Brisbane and Perth — have market power in aeronautical services, but they have not systematically exercised their market power to the detriment of the community. There is no justification for significant change to the current form of regulation of aeronautical services at these airports.

For reasons set out in our initial submission and submissions by A4ANZ, Virgin Australia considers it is clear that each of the major airports has market power in aeronautical services.

The market power of the four monitored airports is recognised by the Commission in the Draft Report. Indeed this also appears to be recognised by the airports themselves, in the submission by the Australian Airports Association. This finding should not be controversial.

However Virgin Australia considers that market power is not limited to the four monitored airports. Other major airports – including other capital city airports and large regional airports – share the same structural characteristics as the four monitored airports, and exhibit similar behaviour. All major airports display natural monopoly features, and these structural features of airports have facilitated conduct which reflects their market power.

In relation to Canberra Airport, the basis for the Commission's finding that the airport does not have a level of market power warranting intervention lies in the availability of road transport alternatives on one route (the Canberra-Sydney route).[1] However road transport is at best a weak substitute for a small number of passengers on one of many routes served by Canberra Airport. As noted by the Commission, Canberra Airport has a high proportion of non-leisure passengers, who are likely to be time-sensitive and who will not view road

[1] Draft Report, p 106.

transport as a viable substitute, including on the Canberra-Sydney route (e.g. business travellers). For routes other than Canberra-Sydney, road transport is unlikely to be a viable substitute for any class of passenger.

Consequently, the availability of road transport alternatives for the Canberra-Sydney route does not place any meaningful constraint on Canberra Airport's market power. **[Commercial-in-Confidence]**

For a number of other airports – including Adelaide, Cairns, Darwin, Gold Coast and Hobart – the Commission appears to consider that market power will be constrained due to a higher proportion of leisure travellers who have flexibility in their holiday destination.[2] Virgin Australia does not agree that, where an airport serves more leisure travellers, its market power will necessarily be more constrained. Travellers may be able to switch between holiday destinations to some extent, although this switching decision will be influenced by a range of factors. However airlines cannot so readily switch between airports serving those destinations, and instead need to maintain a network serving multiple destinations. Consequently, airlines are in a weak bargaining position when seeking to negotiate with any major capital city or regional airport. Examples of this imbalance in bargaining power are set out in section 2.3 below.

2.2 Constraints on the exercise of market power

As noted above, a key conclusion expressed in the Draft Report is that, while (some) airports have market power, they have not systematically exercised their market power to the detriment of the community. Underpinning this conclusion appears to be a view that airlines are in a relatively strong position when negotiating agreements with airports, such that they can exert countervailing power.

The Draft Report notes in particular:[3]

- airports have strong incentives to reach agreements with airlines, including because airports must provide access to airlines under government lease conditions, and airlines can refuse to pay charges determined by the airport where there is no access agreement in place;
- airlines have more mobile capital than airports and are able to reduce or withdraw services at some airports;
- the Commission does not have sufficient evidence that airports are making take-it-or-leave-it offers, and that airlines are compelled to accept them; and
- a number of airports have improved the flow of information needed to facilitate effective negotiations.

Each of these points is addressed below, with reference to further information and evidence, as requested in the Draft Report.

2.2.1 Airports incentives to reach agreement

The Commission's finding that airports have strong incentives to reach agreement with airlines is not consistent with Virgin Australia's experience in seeking to negotiate with airports.

In our experience, airports are often slow to provide information and reluctant to shift their negotiating positions. For example, **[Commercial-in-Confidence]**.

This reflects the incentives faced by airports in negotiating agreements with airlines. Major airports know that airlines require access to their facilities, and many airports consider that the 'back-stop' in the event that agreement cannot be reached is a set of "standard" terms established by the airport – this is certainly the approach taken by **[Commercial-in-Confidence]**, as illustrated by Case Study 1 below. The back-stop terms

[2] Draft Report, p 106.
[3] Draft Report, pp 12-13.

are usually highly unfavourable to airlines, meaning that it is the airline (not the airport) that is more anxious to reach a commercial agreement.

Case Study 1: [Commercial-in-Confidence]

2.2.2 Airlines' ability to reduce or withdraw services

For reasons previously explained, Virgin Australia considers that it cannot credibly threaten to withdraw services from most airports, as doing so would typically inflict much greater harm on us than the airport. While for an airport this would mean the loss of just one airline, for Virgin Australia it would have a significant impact on our network reach and the strength of our customer proposition.

The importance to any airline of maintaining network reach cannot be overstated, particularly for a full service airline such as Virgin Australia. A full service airline seeking to secure its share of the corporate market must offer sufficiently regular services on certain routes (e.g. Canberra). Therefore, a threat to withdraw services on key routes forming part of the network will simply not be credible.

The Commission appears to recognise that threats of service withdrawal are unlikely to be credible, at least in dealing with the large monitored airports. The Draft Report notes that airlines operating in the domestic market are unlikely to withdraw services from the monitored airports, as these locations are gateways to cultural, business or tourism hubs that are not readily substitutable.[4] Virgin Australia considers that the same reasoning could apply to any capital city or major regional airport. From an airline's perspective, having regard to the need to maintain network reach and full service capability, one major airport is not substitutable for another. Consequently, a threat to withdraw services from one major airport and shift capacity to other routes will not be plausible.

The Draft Report correctly observes that airlines can only credibly threaten to withdraw services where the total cost to the airline of doing so, is less than the cost to the airport of losing that airline as a customer. This implies that, at an airport where Virgin Australia faces competition, a threat of service withdrawal will not be credible. For the airport, any revenue lost as a result of losing Virgin Australia as a customer is likely to be made up for through higher revenue from our competitors, who will gain market share at our expense. On the other hand, the cost to Virgin Australia of withdrawing services will be extremely significant, as it would be very damaging to the reach of our domestic and international networks and, therefore, our ability to compete vigorously and effectively against other airlines. Such action by Virgin Australia would also be likely to result in a backlash of community sentiment towards the airline, with associated brand damage.

A threat of service withdrawal is also unlikely to be credible in circumstances where Virgin Australia is competing for, or has entered into, large corporate contracts (in some cases 'whole-of-business' contracts), since these contracts are often reliant on servicing a network of routes and destinations. The case studies below provide examples of where Virgin Australia needs to maintain a network of routes and destinations in order to service large corporate customers. These case studies also demonstrate that restrictions on our ability to withdraw services are not limited to large capital city airports – **[Commercial-in-Confidence]**.

Case Study 2: [Commercial-in-Confidence]
Case Study 3: [Commercial-in-Confidence]

[4] Draft Report, p 121.

2.2.3 Take-it-or-leave-it offers

INFORMATION REQUEST 4.1

The Commission is seeking additional information or examples of take-it-or-leave-it offers by airport operators, including:

- *scope and circumstances of the negotiation*
- *overview of the negotiation process and actions of each party*
- *negotiation outcomes, including acceptance of such offers by airport users*
- *the extent to which such conduct during the negotiation process may reflect an exercise of market power.*

Take-it-or-leave-it offers can come in various forms. In some cases, an airport will be unwilling to budge at all on an element of its pricing (e.g. the rate of return or a capital expenditure project) or certain non-price terms of access. In other cases, the airport may be willing to shift somewhat, but ultimately the airline will be forced to accept unreasonable terms. The two examples below fall into the latter category.

Case Study 4: [Commercial-in-Confidence]

Case Study 5: [Commercial-in-Confidence]

2.2.4 Information provided by airports

The Draft Report notes that some airports have taken steps to improve the flow of timely and relevant information to airlines. Virgin Australia welcomes any efforts by airports to improve transparency and reduce information asymmetries.

However, our experience is that the quality and timeliness of information disclosure by most major airports falls well short of what might be expected in a commercial negotiation where bargaining power is evenly matched.

Case Study 4 above provides one example of where an airport has been very reluctant to provide any information to support its position on access charges, causing significant delay in negotiation.

In another case, **[Commercial-in-Confidence]**.

Therefore, we disagree with the conclusion that airports are providing sufficient information to assist airlines in negotiations. Significant information asymmetries continue to plague many negotiations, contributing to the imbalance in bargaining power between airports and airlines.

2.3 Outcomes of negotiations with airports – risk sharing

INFORMATION REQUEST 4.2

The Commission is seeking additional information on the ways in which airports and airport users share risks through negotiated agreements including:

- *mechanisms to share investment risks, such as offers or use of take-or-pay contracts, where users are required to guarantee a level of future service use*
- *current or proposed contract terms that do not reflect a reasonable sharing of risk, and the rationale for their use*
- *instances where airport users have pre-financed capital projects and why this did or did not represent a reasonable sharing of risk*
- *the extent to which any risk transfer reflects an exercise of market power, and why.*

2.3.1 Mechanisms to share investment risks

Airports use a variety of tools to reduce their risk exposure and shift risk to airlines. This means that airports can invest speculatively in infrastructure required to attract services not currently operating at the airport and pass the risk of that investment onto other airlines by requiring all airlines to fund that investment. The ability for an airport to undertake such speculative investment at low risk only exists because of the market power that airports hold.

Key risk sharing mechanisms used by airports include:

Passenger Volume Risk: Airports use the passenger volume forecast as the basis for pricing, and therefore have the ability to apply a conservative forecast to minimise exposure to downside risk. Airports can also ‘reset’ passenger volume forecasts each time that pricing is reset, thus protecting them from any risk associated with volumes not meeting expectations over the long term – to the extent that volumes fall short of expectations, the cost of this can effectively be passed on to airlines in the form of higher charges. In addition, to compensate them for any passenger volume risk during a pricing period, airports receive a relatively high weighted average cost of capital (**WACC**) (in comparison to regulated infrastructure).[5]

- ***Capital Cost Risks***: Aeronautical fees are set using capital forecasts provided by airports. These forecasts are generally provided with little supporting data and are anticipated to include contingencies sufficient to mitigate any capital risks. Further, aeronautical agreements generally include provisions stating that airports are not obligated to undertake capital investment which therefore allows airports to re-scope or defer capital investment should it be likely that capital forecasts will be exceeded. Airports are also able to include any overspend on capital projects into future pricing periods.

- ***Operating Expense (Opex) Risks***: Airports provide an opex estimate as an input to the price negotiation process. Airlines have little visibility into the efficient operating costs of an airport and therefore are largely unable to challenge these costs. Thus, airports have the ability to include reasonable contingencies in their operating cost forecast to mitigate any risks that actual costs will exceed forecast costs.

In Virgin Australia’s experience, take-or-pay contracts are generally not used as a risk sharing mechanism for aeronautical services.

[5] As noted in our initial submission, some airports seek a pre-tax WACC of 12% or more (Virgin Australia submission in response to the Issues Paper, p 7).

2.3.2 Terms that do not reflect a reasonable sharing of risk

Virgin Australia considers that, in general, pre-funding arrangements do not reflect a reasonable sharing of risk between airlines and airports. To a significant extent, airports are best placed to manage the risks associated with major capital projects, and it is therefore airports who should bear most of the risk associated with these projects. However, invariably, it is airlines that are required to bear almost all of the risk associated with new investment, through pre-funding arrangements. Virgin Australia often considers that it has no choice but to agree to these arrangements.

Pre-funding generally occurs in one of two ways:

- Firstly, pre-funding may occur when an airport specifically levies a new charge to fund an asset that is not yet available to airlines to use.
- Secondly, pre-funding may occur where an airport insists on a fixed increment in charges each year, and this fixed increment is insufficient to fund the level of capital investment required in later years. For example, if an airport seeks steady price increments of 2.5% over the price term, yet capital investment drives a price increase of 2.5% in years 1 to 3 but a 10% increase in year 4 of the term, the price in year 1 needs to be inflated so as to maintain a steady 2.5% increment and not result in a 10% increase in year 4. This means that airlines can, in some cases, start paying for capital projects before any money is spent by the airport, and long before the new infrastructure is available for use.

Virgin Australia considers that several aspects of pre-funding arrangements are not reasonable. In particular:

- These arrangements require airlines to fund infrastructure that they ultimately may not benefit from. For example, an airline operating to Brisbane Airport is currently required to pay for the new parallel runway. However, if that airline ceases to operate to Brisbane Airport, it will not use or benefit from the runway.
- Funding is based on the forecast costs anticipated to be incurred, including a level of contingency. This means airports are paid on capital they may invest rather than capital they actually invest.
- Where airlines are required to pre-fund a capital project designed to improve guest experience, airlines pay higher charges well before airlines or our customers see any benefit from the project.
- Where airlines are required to pre-fund investment designed to address existing capacity constraints, airlines may be suffering the effects, including costs, of congestion associated with the excess demand that results from not having the infrastructure while at the same time incurring the costs associated with delivering the new infrastructure. For example, if airlines are required to pre-fund a new runway to address runway congestion that is causing airborne delays, airlines are incurring additional fuel costs associated with those delays while also paying for the new runway the airlines are not benefitting from.
- Airports, rather than airlines, are in control of the delivery risk associated with new infrastructure. By transferring this risk to airlines through pre-funding, airports have limited incentive to manage these risks to ensure infrastructure is delivered on-time.

The transfer of risk through pre-funding arrangements is yet another way in which airports exercise their market power to the ultimate detriment of consumers. Inefficient allocation of risk under these arrangements will ultimately lead to inefficient investment and higher costs for consumers.

Airports can exercise their market power in this way as airlines have no option but to agree to pre-funding arrangements. As airlines have no alternative to using an airport, they face two options when presented with unreasonable pre-funding arrangements that an airport is unwilling to negotiate on: accept the unreasonable terms; or refuse to accept the terms and risk being reverted to the airport’s standard Conditions of Use, which are typically even more unfavourable to the airline.

2.4 Airports' financial performance

Virgin Australia is concerned that the Commission's analysis of airports' financial performance is incomplete and risks missing key indicators of airports' market power.

In particular, the Commission has chosen to ignore Frontier Economics' analysis of airports' profitability (submitted by A4ANZ), which shows that several of the major airports have been persistently earning excess returns. This analysis is discussed in detail in A4ANZ's submission in response to the Draft Report.

Even based on the Commission's very limited indicators of airports' financial performance, there is evidence of market power exploitation. In particular:

- the Draft Report notes that Sydney Airport's very high returns on aeronautical assets "*could present cause for concern when considered in isolation*" (the Draft Report then goes on to dismiss these concerns, attributing high profits at Sydney Airport to "scarcity rents").[6] Whereas the Draft Report notes that airports' cost of capital should have fallen by about 3 percentage points between 2008 and 2018, Sydney Airport's rate of return has actually increased significantly over this period;[7]

- analysis in the Draft Report shows that operating profit margins of the monitored airports are very high by international standards;[8] and

- the Draft Report identifies high charges for international services at Sydney and Brisbane, and says that it is not possible to rule out that these high charges are due to those airports exercising their market power.[9]

The high level of returns earned by airports is not surprising to Virgin Australia, given our experience in seeking to negotiate on this issue. As previously noted, airports often seek to earn a very high level of return through access charges.[10] Virgin Australia has had little success in seeking to negotiate with airports around the allowed rate of return, and invariably we have little choice but to agree to what the airport is seeking. We expect that, in the absence of a negotiate-arbitrate framework, we will continue to face difficulties in negotiating with airports around the rate of return, and consequently, airports will continue to earn very high returns and profit margins.

Virgin Australia considers that the weight of available evidence in relation to airports' financial performance – including both the evidence presented in the Draft Report and the analysis by Frontier Economics – is consistent with those airports exercising market power in the setting of access charges.

[6] Draft Report, pp 16-17
[7] Draft Report, pp 165-166.
[8] Draft Report, p 169.
[9] Draft Report, pp 272, 299.
[10] Virgin Australia submission in response to the Issues Paper, p 7.

3. Access Arrangements at Sydney Airport

DRAFT RECOMMENDATION 7.1 – REGIONAL ACCESS TO AND FROM SYDNEY AIRPORT

The Australian Government should amend the Sydney Airport Slot Management Scheme 2013 (Cwlth) to allow slots that are not part of a permanent regional service series (PRSS) to be used for either regional or non-regional flights. These slots should not become PRSS slots when used for regional flights.

Future Declarations relating to the regional price cap and notification regime should only apply to regional flights operated through PRSS slots, after the current Declaration no. 94 ceases on 30 June 2019.

DRAFT RECOMMENDATION 7.2 – COMMERCIAL NEGOTIATIONS FOR NSW REGIONAL SERVICES

The Australian Government should ensure that future Declarations relating to the regional price cap and notification regime at Sydney Airport only apply to aeronautical services that are not covered in commercial agreements between Sydney Airport and airlines operating NSW regional air transport services, after the current Declaration no. 94 ceases on 30 June 2019. Future Declarations should also specify that prices in commercial agreements cannot be used to assess whether Sydney Airport has breached section 95Z of the Competition and Consumer Act 2010 (Cwlth).

For reasons set out in Virgin Australia's initial submission, we support the recommendation to make non-PRSS slots available for regional services.

In relation to the scope of future Declarations relating to the regional price cap and notification regime at Sydney Airport, this is a matter which Virgin Australia is considering and will address in its submissions to the Australian Government.

INFORMATION REQUEST 7.1

The Commission invites comments on the potential costs and benefits of reforms to Sydney Airport's regulatory constraints on aircraft movements that can also meet current noise objectives.

Options that could improve the efficiency of the movement cap without leading to a net increase in noise include:

- *spreading the measurement of the movement cap over a longer time period than the current measure of 80 movements per 15-minute rolling hour*
- *removing the cap on actual movements but retaining a cap on scheduled movements.*

Options that could improve the targeting of noise outcomes include:

- *replacing regulatory constraints on aircraft movements with noise caps based on the amount of noise made by each aircraft*
- *adopting noise-based criteria for determining which aircraft are permitted to operate during the curfew, rather than the current prescribed list of aircraft types.*

The Commission has invited comments on the potential costs and benefits of reforms to Sydney Airport's regulatory constraints on aircraft movements that can also meet current noise objectives.

Movement cap

In relation to options that could improve the efficiency of the movement cap without leading to a net increase in noise, Virgin Australia supports removing the cap on actual movements while retaining a cap on planned scheduled movements.

As Australia's busiest airport in terms of passenger numbers, managing demand at Sydney Airport in accordance with current regulations is becoming increasingly challenging, resulting in a substantial loss of airline operational efficiency at the airport on a daily basis. Given Sydney Airport's central role in the Australian aviation network, sub-optimal processes for managing demand at the airport have significant implications for Virgin Australia and other airlines, which are particularly severe in disruption scenarios. With demand already exceeding capacity during peak periods and total annual aircraft movements at the airport expected to increase from around 348,000 in 2017 to more than 408,000 by 2039,[11] there is a strong need to reform elements of the current suite of operational restrictions at Sydney Airport in order to maximise the efficiency of operations, while preserving protections in place for surrounding communities in relation to aircraft noise. Without such reform, it is inevitable that unduly complex and inflexible measures for the administration of the movement cap will lead to increased flight cancellations and delays, both at Sydney Airport and across the network.

Virgin Australia notes that the key policy objectives of the Sydney Airport Demand Management Act 1997 (**Act**) include the administration and protection of the integrity of the limit on aircraft movements of 80 per hour (the movement cap), as well as the facilitation of the efficient operations of the airport. In our view, certain regulatory requirements associated with the first objective of safeguarding the movement cap can, at times, represent a practical impediment to the achievement of the second objective concerning efficient operations. While Virgin Australia would welcome regulatory amendments, which have the aim of aligning the requirements for managing demand with the practicalities of airport operations, it is appropriate that legislative protections for matters of public interest concerning Sydney Airport, such as the night time curfew, the movement cap itself, access for regional services and the Long Term Operating Plan (**LTOP**), continue to exist.

The Act contains an inconsistency in relation to the enforcement of the movement cap based on aircraft movements (runway take-offs and landings) on the one hand, and gate movements or slots on the other. Notwithstanding that the allocation of gate movements under the Sydney Airport Slot Management Scheme 2013 (**Slot Management Scheme**) must be performed in accordance with the movement cap, the Demand Management Act also requires Airservices Australia (**AA**) to monitor actual runway movements to ensure strict compliance with the movement cap during each 15-minute rolling hour (regulated hour). AA employs a number of full-time equivalent staff to perform this function, who manually count runway movements on the day of operation. This unnecessary and costly duplication of compliance measures is significantly curtailing the efficiency of operations at Sydney Airport, contrary to one of the key objectives of the Demand Management Act as noted above, and to the detriment of the aviation industry and the travelling public.

As noted in the Draft Report, the requirement for AA to monitor compliance with the movement cap has resulted in a conservative approach to handling traffic at Sydney Airport in situations where runway movements are approaching 80 in any regulated hour. Almost every day, Virgin Australia is notified by AA that there will be periods, known as cap threat periods, where scheduled movements risk breaching the movement cap. These cap threat periods are generally during the morning and afternoon peak periods. On 27 of 30 days between mid-November and mid-December last year, airlines were notified of cap threat periods of up to four hours in duration.[12]

As scheduled movements for each regulated hour during peak periods are allocated to permit 80 movements, any minor change to an airline's schedule, or an ad hoc police/ambulance flight, could cause a breach of the movement cap. In these scenarios, AA will manage movements to ensure they remain below 78 or 79 per regulated hour. This results in periods of time during which no runway movements are permitted, where aircraft are held at the runway holding point burning fuel while awaiting the commencement of the next regulated hour,

[11] *Sydney Airport Master Plan 2039*.
[12] Based on most recent data provided by Airservices Australia.

and even cases where aircraft are required to instigate a missed approach and later re-enter the landing pattern sequence, in circumstances where the landing would have resulted in a potential breach of the movement cap.

During severe thunderstorms affecting the Sydney area, aircraft rarely depart and instead queue on taxiways waiting for the weather to clear. Simultaneously, aircraft bound for Sydney will enter holding patterns until the weather improves. As soon as weather conditions permit the recommencement of safe operations, there is a high demand for usage of the runways by both landing and departing aircraft. In these situations, AA will prioritise landing aircraft, but face pressure to clear congested taxiways to allow arriving aircraft access to gates. Assessing the movement cap according to each regulated hour limits the ability of AA to approve the departure of aircraft, unnecessarily lengthening ground delays and causing further difficulties for airlines as they seek to re-establish orderly operations. Enabling AA to process runway movements without reference to a movement cap would allow airlines serving the airport to return to scheduled operations more efficiently following these types of events. This would balance the needs of the travelling public and surrounding communities, as increased runway movements following a disruption would be offset by the corresponding decline in runway movements during a disruption, with no overall impact on a movement cap assessed in terms of planned gate movements and no net increase in noise.

In addition, the movement cap significantly restricts the ability of airlines to recover their schedules following systems or facilities outages at the airport. As an example, Virgin Australia and other airlines services were severely impacted by an air traffic control system failure on the morning of 25 September 2017. Initially, all flights due to depart Sydney Airport were instructed to remain on the ground, followed by very low levels of acceptance until the system was substantially restored three hours later. Due to the backlog of delayed services, airlines could not operate all of their disrupted flights due to enforcement of the movement cap according to runway movements per regulated hour. In order to return our schedule to planned operations, Virgin Australia cancelled 20 flights into and out of Sydney, and a further six flights into and out of Melbourne as a flow on effect, inconveniencing thousands of passengers. If the movement cap was based on planned gate movements rather than runway movements, it is likely that fewer flights would have been cancelled in this scenario as AA would have had the ability to process more flights as they presented, notwithstanding that this may have resulted in more than 80 runway movements occurring in an hour while the backlog of flights was cleared.

Airline schedule development occurs from six to 13 months ahead of operation and is based on planned gate movements. It is impossible for airlines to plan schedules based on runway movements at Sydney Airport, due to the range of factors that may impact operations on any given day, including weather and unpredictable taxi times. In the interests of on time performance and customer satisfaction, airlines will, wherever possible, seek to operate their services at Sydney Airport in accordance with schedules constructed on the basis of gate movements which have been allocated by the Slot Manager in compliance with the movement cap. Accordingly, the integrity of the movement cap is adequately safeguarded by the process of allocating gate movements under the Slot Management Scheme and will not be compromised if conditions affecting runway movements on the day of operations result in such movements occurring at times which deviate from the planned schedule.

Virgin Australia therefore recommends that the Demand Management Act is amended to provide that the movement cap is assessed in terms of planned gate movements only, through the removal of the requirement for AA to monitor compliance with the movement cap. This will allow AA to manage traffic as it presents according to prevailing conditions on the day of operations, based on airline schedules planned in accordance with slot allocations which comply strictly with a movement cap based on gate movements. In essence, the schedule planning process itself would ensure compliance with the movement cap. This would deliver significant benefits for airlines in periods of peak demand, by eliminating an unnecessary restriction on the utilisation of airfield infrastructure. In addition, it would facilitate efforts by airlines to recover from schedule disruptions by clearing the backlog of flights as efficiently as possible, minimising delays and cancellations and the associated inconvenience for passengers. From both an economic and social perspective, this reform would deliver significant benefits.

To ensure the Slot Management Scheme is functioning as intended, it would also be desirable to introduce a legally-effective slot compliance scheme, capable of penalising airlines for deliberate and sustained failures to comply with slot allocations. As noted below, however, Virgin Australia does not endorse Draft Recommendation 7.3.

Noise outcomes

In relation to options that could improve the targeting of noise outcomes, Virgin Australia supports the adoption of noise-based criteria for determining which aircraft are permitted to operate during the curfew, rather than the current prescribed list of aircraft types.

Currently, Virgin Australia is not able to meet customer demand for carriage of cargo both into and out of Sydney Airport during the curfew period, as we only have access to 18 of the 74 slots available each week for dedicated freighter services and we are limited to operating BAe-146 aircraft, carrying a maximum of 9,500 kilograms on each of the Melbourne-Sydney, Sydney-Brisbane and Sydney-Melbourne sectors. Permitting operations during the curfew period with any type of low-noise dedicated freighter aircraft which complies with the maximum noise levels specified in Volume 1 of Annex 16 to the Chicago Convention would enable Virgin Australia and other airlines to serve Sydney Airport with a higher capacity and quieter aircraft type.

In addition to providing air freight operators with increased flexibility, this proposal has the potential to reduce the night time noise exposure for communities surrounding Sydney Airport, as there are other types of dedicated freighter aircraft in operation with lower noise profiles than the BAe-146 aircraft. It would also be consistent with the legislative frameworks in place for Adelaide and Gold Coast airports, which do not specify the type of dedicated freighter aircraft that may be used during curfew periods. This would streamline the regulatory requirements for air freight operators, delivering efficiencies for the aviation and freight forwarding industries.

Overnight dedicated freighter market competition and efficiency

Under the Sydney Airport Curfew Regulations 1995 (the Curfew Regulations), a maximum of 74 slots each week is available for the operation of dedicated freighter operations during the curfew period. As noted above, Virgin Australia has access to and uses 18 of these slots each week. The rest of the slots are held by Cobham Aviation Services (28 slots), Qantas Airways (27 slots) and Toll Transport (1 slot).

While we recognise that enabling operators to use larger aircraft types (which meet specified maximum noise level) will provide scope for a significant increase in uplift capacity during the curfew, it will nonetheless be important to ensure that all operators are actually utilising the movements they have been allocated under the legislative framework, to maximise efficiency, productivity and competition across the industry. Without a legislative mechanism to assess such utilisation and revoke or reallocate any unutilised movements, it would seem that dedicated freighter operators could retain any unutilised movements in perpetuity, despite the fact that there is another operator that may like to schedule more services in the curfew period during times of peak demand.

The introduction of a mechanism for assessment and revocation or reallocation of movements would have the potential to boost competition among existing operators named in the Curfew Regulations, as well as encourage new operators to the market if unutilised slots were available for allocation. With half of Australia's international air freight and approximately one third of domestic air freight handled at Sydney Airport,[13] enhanced competition has the potential to deliver benefits for the freight forwarding industry and consumers alike. Ideally, this would include:

- principles governing the allocation of slots;

[13] *NSW Draft Freight and Ports Plan*, p 49.

- a requirement for air cargo operators to regularly report on utilisation of slot allocations;
- a requirement for the Government to report on utilisation of slot allocations; and
- a mechanism which enables the Government to reallocate unutilised slots.

Although Virgin Australia appreciates that the Demand Management Act and its associated legislative instruments do not apply to movements during the curfew period, one of the key principles under the International Air Transport Association's (**IATA**) Worldwide Slot Guidelines regarding the allocation and use of slots for aircraft at slot-constrained airports is that operators must be able to demonstrate at least 80% utilisation of the relevant slots during a scheduling season in order to retain historic precedence to those slots in a subsequent scheduling season (the 'Use it or Lose it rule').[14] If slots are not sufficiently utilised, they will be returned to the pool and made available for allocation to other carriers. This prevents airlines from retaining slots that would otherwise be used by other airlines, in order to maximise the productivity of the infrastructure at the relevant airport.

For all flights during the non-curfew period, and for permitted dedicated freighter operations during the curfew period, the total number of slots that may be operated is artificially limited by legislation. Accordingly, the same principle regarding the utilisation of slots should apply to all aircraft movements at Sydney Airport, irrespective of whether they occur during curfew or non-curfew periods. As the overnight air freight task in Sydney and across the rest of Australia is likely to grow in the future, it is vital that relevant legislative frameworks are capable of supporting such growth. This would also be consistent with the rationale for developing a National Freight and Supply Chain Strategy. It may therefore be appropriate that the Demand Management Act and its associated legislative instruments are amended in order to encapsulate slot allocation during the curfew.

It is also worth noting that the legislative framework governing the operations of the International Air Services Commission incorporates a similar mechanism, to prevent the stockpiling of capacity by Australia's international airlines in the interests of promoting economic efficiency through competition in the provision of international air services.

DRAFT RECOMMENDATION 7.3 – REVIEWING SYDNEY AIRPORT'S SLOT MANAGEMENT SCHEME

The Australian Government should commission a public review of the Sydney Airport Slot Management Scheme 2013 (Cwlth) following the outcomes of the International Air Transport Association's review into the Worldwide Slot Guidelines, expected to be completed in 2019.

The review of the Scheme should assess how effectively it contributes to the efficient use of scarce airport infrastructure while taking into account regional access and noise management objectives. It should consider reform options in relation to:

- *whether slot allocation arrangements generate the greatest benefits to the community or if alternatives that are not based on historical precedence would improve competition*
- *slot performance monitoring to ensure that slots are being used in accordance with the intent of the Scheme*
- *the costs and benefits of continued alignment with the latest Worldwide Slot Guidelines, including the effects on competition between airlines.*

Virgin Australia does not support Draft Recommendation 7.3, on the basis that a separate public review of the Slot Management Scheme is entirely unnecessary given IATA's current strategic review of the Worldwide Slot Guidelines (**WSG**). This comprehensive, industry-led review was commenced by IATA in June 2016 and

[14] *Worldwide Slot Guidelines effective 1 January 2018*, International Air Transport Association, 8.1 edition, paragraph 8.6.

involves consultation with all key stakeholders, including Airports Council International and Worldwide Airport Coordinators Group.

Established in 1974, the WSG have been regularly updated and enhanced as a result of consultation between airlines and airport coordinators/slot managers and allow for the recognition of local procedures and requirements. The WSG represent proven best practice for the global coordination and management of airport slots and planned operations, including historic precedence and the determination of competing slot applications. They provide a consistent framework of principles, policies and processes for the allocation of slots at capacity-constrained airports across the world, in order to optimise the utilisation of scarce airport infrastructure and support the growth of air services. As each flight serves two airports, the efficiency of airline operations depends on the existence of a common and harmonised approach to slot allocation across the global aviation network.

The WSG are premised on the four cornerstones of certainty of access; flexibility to mix and match slots to meet operational challenges and changing market needs; sustainability of costs; and transparency of allocation.[15] In relation to certainty of access, the WSG provide a framework for airlines to plan for the deployment of aircraft on particular routes, which is directly relevant to fleet investment decisions. Accordingly, the allocation of slots according to historical precedence is critical to ensure that airlines continue to have the confidence to invest in new aircraft. Historical precedence also gives airlines the ability to offer services for sale to the travelling public as much as 12 months in advance of travel. Alternatives slot allocation processes, which are not based on historical precedence, would be completely unworkable and impractical for airline scheduling.

The WSG incorporate processes for slot allocations to new entrants, providing scope for increased competition in aviation markets. Access for new entrants is, however, necessarily dependent on the infrastructure availability at the relevant airport. At airports where investment in infrastructure to accommodate growth in passenger traffic and aircraft movements has not occurred, it is challenging for any operator to increase their services. In the case of Sydney Airport, this is exacerbated by artificial operational constraints and delays associated with the decision to establish a second airport in Sydney. Arrangements for new entrant access are being considered as part of IATA's strategic review of the WSG.

While the Slot Management Scheme incorporates regulations designed to deliver policy outcomes specific to Sydney Airport, it is principally based on the WSG. If Sydney Airport or the Australian Government sought to introduce additional local rules which depart from the WSG, airlines would be constrained in their ability to offer the routes and timings that passengers desire. This would not foster increased competition between airlines; rather, it would introduce inefficiencies in airline and airport operations.

Departure from the WSG would also have the potential to set a precedent which may encourage other governments and airports to look at introducing new or additional local rules for slot allocation. Over time, this may erode the global harmonisation and consistency in slot allocation processes that has been achieved under the auspices of WSG over the last 45 years. Airline productivity would be expected to decline, as would airport operational efficiency, which may lead to reduced connectivity and convenience for passengers, as well as an increase in airfares. Overall, the benefits of continued alignment with the WSG outweigh any costs, especially in the context of the pressures that increasing global demand for air services will place on airport infrastructure in the future.

[15] *Managing Scarce Airport Capacity: Airport Slots & Worldwide Slot Guidelines (WSG),* International Air Transport Association.

4. Competition in Markets for Jet Fuel

DRAFT FINDING 8.1

The supply of jet fuel at some Australian airports is characterised by conflicts of interest associated with fuel companies owning the Joint User Hydrant Installation infrastructure, and a lack of open access arrangements to infrastructure services needed to supply jet fuel.

There is limited transparency on the terms of third party access to infrastructure services, which makes it difficult for potential competitor fuel suppliers to decide whether to enter a market or to assess whether these terms are reasonable.

Prima facie, this has enabled incumbent fuel suppliers to restrict competition in markets to supply jet fuel, leading to some airports having a small number of fuel suppliers, and has likely led to higher prices to access infrastructure services and higher fuel prices.

4.1 Restrictions on competition and impact on fuel prices

Virgin Australia endorses the draft findings in relation to restrictions on competition in the supply of jet fuel. These findings are consistent with our experience in seeking to acquire jet fuel on competitive terms at major airports.

For example, restrictions on competition in the supply of jet fuel at Melbourne Airport have led to significant price increases and supply shortages in recent years. Recent growth in demand at Melbourne Airport coupled with under-investment in airport fuel infrastructure has led to notable supply shortages and higher fuel pricing, relative to other major Australian airports. Virgin Australia endured significant price increases at Melbourne Airport following significant fuel shortage events in late 2016.

INFORMATION REQUEST 8.1

The Commission is seeking information from participants on markets to supply jet fuel at the capital city airports.

Airlines (both domestic and international):

- *prices paid per litre of fuel at each capital city airport*
- *the number of fuel suppliers tendering for contracts, and the number of successful tenderers, at each capital city airport*
- *the estimated additional costs (including, for example, the price differential) faced by airlines due to a lack of competition in the jet fuel supply chain*
- *the extent to which airlines substitute the location where they uplift fuel to take advantage of better prices.*

This information should be provided to the Productivity Commission in a form that can be published and scrutinised.

Virgin Australia has compiled the information sought from airlines in Information Request 8.1. To allow this information to be provided to the Commission in a form that can be published and scrutinised, this information will be provided along with information to be provided by other airlines in a submission to be lodged by IATA.

4.2 Fuel throughput levies

The Draft Report notes that airports charging a throughput levy without providing any service will increase the cost of jet fuel and, potentially, the price of airfares.[16]

The submission lodged by the Board of Airline Representatives of Australia (**BARA**) provides one example of a fuel throughput levy being charged without any service being provided.[17] The case cited by BARA – relating to Sydney Airport – is a clear example of a "*fee for no service*" being imposed by a monopoly airport. Given that no service is being provided to justify this levy, it simply represents an additional monopoly rent being extracted by the airport. This is yet another example of airlines being powerless to prevent the exploitation of monopoly power by major airports.

Virgin Australia pays fuel throughput levies at a number of other major airports, including:

- **[Commercial-in-Confidence]**; and
- **[Commercial-in-Confidence]**.

There is insufficient transparency as to the basis for these charges, and as such, we are unable to assess whether they are justified.

4.3 Providing for open access

DRAFT RECOMMENDATION 8.1 – OPEN ACCESS JUHI AT WESTERN SYDNEY AIRPORT

Through the Shareholder Ministers of the Western Sydney Airport Corporation (the Minister for Finance and the Minister for Urban Infrastructure), the Australian Government should recommend to the Western Sydney Airport Corporation Board that the Joint User Hydrant Installation infrastructure operate on an open access basis and that this should be a condition of any future privatisation.

Virgin Australia welcomes the recommendation for open access to jet fuel infrastructure at the new Western Sydney Airport. We have previously advocated for an open access regime, to improve the conditions for competition in the supply of jet fuel at major airports.[18]

We consider that similar recommendations should be made in respect of jet fuel infrastructure at existing airports. It is not clear why the same remedy should not apply at existing airports, given the structural barriers to competition identified by the Commission.

The only reason given in the Draft Report for not imposing open access obligations at existing airports is that the Commission considers that regulation would come with costs, including administrative and compliance costs, and the risk of regulatory error.[19] Virgin Australia submits that any costs of effective regulation are likely to be small, and will be far outweighed by the benefits of enhanced competition in the supply of jet fuel at major airports.

[16] Draft Report, p 262.
[17] BARA submission in response to the Draft Report, 7 March 2019, pp 27-28.
[18] Virgin Australia submission in response to the Issues Paper, pp 27-28.
[19] Draft Report, p 266.

4.4 Supply coordination

DRAFT RECOMMENDATION 8.2 – INTRODUCING A JET FUEL SUPPLY COORDINATION FORUM

The Minister for Infrastructure should recommend a jet fuel supply coordination forum be incorporated into the master planning process at each monitored airport. The forum should be tasked with discussing, among other things:

- *capacity constraints and any potential pressure points*
- *linkages between infrastructure*
- *demand forecasts and security of supply*
- *future infrastructure requirements and investment planning.*

For reasons set out in our initial submission[20] and the submissions lodged by BARA[21], Virgin Australia supports this recommendation.

[20] Virgin Australia submission in response to the Issues Paper, pp 27-28.
[21] BARA submission in response to the Draft Report, 7 March 2019, pp 26-27.

5. Reform Directions

5.1 Addressing ant-competitive contract provisions

DRAFT RECOMMENDATION 10.1 – PREVENTING ANTICOMPETITIVE CONTRACT PROVISIONS

The Australian Government should amend the Aeronautical Pricing Principles to specify that any agreement between an airport and an airport user must not contain anticompetitive clauses. This includes clauses that would constrain that user's access to regulatory remedies for the exercise of market power or that directly or indirectly reference the terms being offered to users' competitive rivals.

5.1.1 Provisions that seek to constrain a user's access to regulatory remedies

The Commission has noted that some agreements contain provisions which establish disincentives or loss of contractual rights where an airline is involved in a declaration application under the National Access Regime (Part IIIA of the Competition and Consumer Act 2010 (Cth) (**CCA**)). The Commission considers that such provisions should be removed from all agreements.

Virgin Australia agrees that provisions restricting an airline's ability to exercise its statutory rights under the National Access Regime have no place in commercial agreements for access to critical infrastructure such as airports. However, we do not consider this to be an isolated issue of 'anticompetitive clauses' which simply need to be excised from relevant agreements. Rather, this is symptomatic of a gross imbalance in bargaining power as between airports and airlines.

Therefore, we do not consider that the appropriate remedy is to simply prohibit such clauses. This would be to treat one symptom of a much broader issue, without treating the underlying cause.

Rather, we consider that a more comprehensive solution is required to address the imbalance in bargaining power as between airports and airlines. Our proposed solution to this broader issue is discussed in section 5.3 below.

INFORMATION REQUEST 10.1

The Commission invites evidence about anticompetitive clauses in commercial agreements between airports, airlines, landside operators and other airport users.

In Case Study 1 above, we have provided an example of where an airport sought to restrict access by Virgin Australia to declaration remedies under the National Access Regime. In that case, the attempt to restrict access to Part IIIA was accompanied by a threat that, if Virgin Australia sought declaration, its agreement with the airport would be terminated and it would revert to the airport's standard Conditions of Use.

5.1.2 Provisions that directly or indirectly reference the terms being offered to users' rivals

Virgin Australia does not consider it necessary or appropriate to impose an outright ban on provisions in airport access agreements that "*directly or indirectly reference the terms being offered to users' competitive rivals*".

Such provisions will not necessarily be anti-competitive, and indeed may be pro-competitive and/or efficiency-enhancing in some cases. So much is recognised in the design of the general competition law – under the CCA, making or giving effect to an agreement containing such provisions would only be prohibited where this

has the purpose, effect, or likely effect of substantially lessening competition.[22] The CCA does not provide for an outright ban on provisions which reference the terms being offered to competitors' rivals. Indeed, such provisions are relatively common in commercial agreements, and are rarely found to contravene the general competition law.

It is not clear why such provisions should be banned from agreements between airports and airlines. The Draft Report does not explain why they should be seen as *per se* problematic in this particular industry, but not in others.

[Commercial-in-Confidence]

Clearly, to the extent that such provisions do have the purpose, effect or likely effect of substantially lessening competition, remedies would be available under the general competition law. It is not necessary to impose an industry-specific ban on such provisions through the Aeronautical Pricing Principles.

5.2 Enhanced monitoring

DRAFT RECOMMENDATION 10.2 – FUTURE PRODUCTIVITY COMMISSION REVIEWS

The Australian Government should request the Productivity Commission to inquire into the regulation of airports in 2024, to determine the effectiveness of the regulatory regime in achieving the following objectives:

- *promoting the economically efficient operation of, and timely investment in, airports and related industries*
- *minimising unnecessary compliance costs*
- *facilitating commercially negotiated outcomes in airport operations.*

In requesting the inquiry, the Australian Government should also ask the Commission to consider whether:

- *any airports should be added to, or removed from, the list of monitored airports*
- *there is a continued need for arrangements to help facilitate access for airlines that provide flights to regional New South Wales.*

The Australian Government should stipulate in the terms of reference for that inquiry that, on request, the monitored airports should make their agreements with airport users available to the Productivity Commission on a commercial-in-confidence basis.

DRAFT RECOMMENDATION 10.3 – DISCONTINUE SECOND-TIER AIRPORT MONITORING

The Australian Government should issue a statement that the voluntary self-reporting system for second-tier airports is discontinued.

[22] CCA, s 45.

DRAFT RECOMMENDATION 10.4 – MORE DETAILED INFORMATION ON AIRPORT PERFORMANCE

The Australian Government should amend part 7 of the Airports Regulations 1997 such that, in addition to current requirements, monitored airports are required to provide to the Australian Competition and Consumer Commission (ACCC), for each financial year, statements that:

- *show the number of passengers that depart from and arrive at each terminal*
- *separately show the costs and revenues in relation to the provision and use of aeronautical services for domestic flights and for international flights*
- *for Sydney Airport, also show the costs and revenues in relation to the provision and use of aeronautical services for flights to regional New South Wales*
- *separately show the number of users, costs and revenues in relation to the provision and use of at-terminal and at-distance car parking and the utilisation rates for each type of parking*
- *separately show the number of vehicles that use landside access services, charges and other terms of access for each landside service, and the operating costs and revenues in relation to the provision and use of the various landside access services, such as services for shuttle buses, taxis and hire cars*
- *report all costs on the basis that they are specific to a service or common across more than one service (stating the relevant services). In addition, airports should report costs on an allocated basis and should clearly set out the methodologies used for allocating the costs to international and domestic aeronautical services; at-terminal and at-distance parking; and landside access services.*

The ACCC should continue to publish annual monitoring reports. It should audit and publish a database of the information the airports provide. The ACCC should publish the methodologies the monitored airports use to allocate costs across different services.

DRAFT RECOMMENDATION 10.5 – IMPROVING QUALITY OF SERVICE MONITORING

The Australian Competition and Consumer Commission (ACCC) should, within 12 months, provide advice to the Australian Government on an updated set of quality of service indicators, in consultation with airports, airlines and other airport users.

Once the ACCC has developed its recommended list the Australian Government should amend schedule 2 of the Airports Regulations 1997 to codify the updated list of indicators.

Virgin Australia is concerned that the Commission's recommendations for further and enhanced monitoring of airports' performance do not go nearly far enough. Continued ACCC monitoring and the prospect of another Commission inquiry in 2024 will not provide any meaningful constraint on airports' market power.

Mere monitoring of airports' behaviour, and the "naming and shaming" of airports' abuse of market power by the ACCC has been, and will continue to be, ineffective. Periodic reviews by the Commission have similarly not prevented the exercise of market power by airports.

The Commission correctly observes that there are limitations in the data and metrics available to the ACCC in performing its monitoring role.[23] Virgin Australia has previously noted limitations in the reporting of airport returns in particular, due to the fact that the asset values used in this calculation are unlikely to be truly representative of the economic value of airport assets.[24]

[23] Draft Report, Chapter 5.
[24] Virgin Australia submission in response to the Issues Paper, p 11.

However, the Commission does not seek to address many of these limitations in its draft recommendations. While recommending greater transparency around landside operations and cost allocation, the Draft Report shies away from any recommendation for more informative monitoring benchmarks, stating that "setting benchmarks is complex and imprecise".[25] In relation to setting an appropriate value for the airport asset base, the Draft Report expresses concern that "the matter would be contested by airports", and that this could lead to legal action, policy and investment uncertainty and high administrative costs.[26]

With respect, we consider that this is not a valid reason to forbear from improvements to the regulatory regime. Evidently, any regulatory reform which places greater constraint on airports' exercise of market power will be contested by airports. Indeed, the history of regulatory reform in other industries shows that access providers will always resist enhanced regulation, and will often contest it fiercely. However, this is not a good reason to maintain a sub-optimal regulatory regime.

It also not clear why airports should be viewed differently to other monopoly service providers in this regard. In other industries where regulation is applied to constrain the exercise of market power, benchmarks for pricing are set based on long-run average costs. This often involves a regulator either establishing a value for the asset base to reflect the undepreciated value of assets used to provide services, or at least establishing clear guidelines for service providers to report this value.[27] Setting appropriate benchmarks for airports would be no more complex or contentious than the exercises that have been undertaken in other industries, and is likely to be less so, given the nature of the assets involved – for example, establishing an appropriate value for airport infrastructure is likely to be less complex than for, say, a large telecommunications or electricity distribution network.

In our initial submission, we provided some recommendations for improvements to the monitoring regime. These included extension of monitoring to other major capital city and regional airports, and new requirements for airports to report the written down value of their assets using a recovered capital methodology.[28] We are disappointed that these recommendations are not considered in the Draft Report.

More fundamentally, we are concerned that the mere continuation of monitoring based on limited performance measures will not be effective, so long as there is no real prospect of regulatory sanction for the exploitation of market power.

5.3 Addressing the imbalance in bargaining power in commercial negotiations

Virgin Australia continues to support A4ANZ's proposal for an industry-specific negotiate-arbitrate regime. We consider this to be the most practical solution available to constrain airports' ability to exercise market power.

We consider that the criticisms levelled at this proposal in the Draft Report are misplaced. In particular:

- **Need to consider other airport users**. Regulators and arbitrators in other industries are frequently required to consider the potential effect of their determinations on other users of the facility in question. Indeed almost all facilities that are subject to a negotiate-arbitrate form of regulation are multi-user facilities – this includes gas pipelines subject to a negotiate-arbitrate framework under Part 23 of the National Gas Rules, and the Port of Newcastle, which was recently the subject of an ACCC arbitration determination. The need to consider the requirements of other users is often expressly recognised in

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[25] Draft Report, p 305.
[26] Draft Report, p 305.
[27] For example, asset values for covered gas pipelines were previously established either by the ACCC (for most covered transmission pipelines) or by jurisdictional regulators (for distribution assets), and are now rolled forward in accordance with a prescribed formula set out in rule 77 of the National Gas Rules. For non-scheme (uncovered) gas pipelines, the AER has established guidelines for reporting of asset values based on the recovered capital method (AER, *Financial Reporting Guideline for Non-Scheme Pipelines*, December 2017).
[28] Virgin Australia submission in response to the Issues Paper, pp 11-12.

legislation governing the arbitration of disputes.[29] This is a common issue, and one that can be readily overcome.

- **Need for an arbitrator to resolve differences of opinion over investment requirements**. This is similarly a common issue for regulators and arbitrators. Regulators and arbitrators are frequently called upon to make judgements as to the prudency of proposed investments. In making these judgements, a regulator or arbitrator will be able to rely on expert evidence, including economic and/or engineering opinions. The need for a regulator or arbitrator to make complex judgements should not be a barrier to regulatory reform. Virgin Australia considers that, at least in some cases, it is likely to be better for such judgements to be made by an expert arbitrator or regulator, rather than being left in the hands of a monopolist.

- **Potential for "shadow price regulation"**. The Draft Report expresses particular concern around the risk of "shadow price regulation", which the Commission considers is likely to be time-consuming, costly and distracting. This appears to be no more than a general concern about the potential costs of greater regulatory oversight. Virgin Australia does not share these concerns. While we recognise that any regulatory mechanism will have some cost, we consider that any cost associated with the proposed negotiate-arbitrate regime will be far outweighed by its benefits, in terms of constraining airports' market power.

  We also consider that the potential time and cost involved in resolving negotiations under a negotiate-arbitrate regime need to be compared with the status quo. Virgin Australia has previously provided information which demonstrates that its commercial negotiations with airports can drag on for many years, as a result of airports lack of incentive to provide reasonable offers and supporting information in a timely manner (e.g. see Case Study 4 above). By contrast, Virgin Australia understands that, under negotiate-arbitrate regimes in other industries, negotiations and any related disputes can be resolved relatively quickly – i.e. in less than six months.[30] The regime under Part 23 of the National Gas Law provides an example of how access providers can be incentivised to provide reasonable offers and supporting information in a timely manner, thus reducing the time required to reach a resolution.

Virgin Australia understands that regulation can create significant costs, and that these costs need to be weighed against any benefit. It is for this reason that we support the A4ANZ proposal, which represents a limited and proportionate response to airports exercising market power. Importantly, this model maintains the primacy of commercial negotiations, and only provides for intervention where negotiations fail. It is our hope that arbitration will rarely (if ever) be required, because airports will face stronger incentives to provide reasonable offers and supporting information in a timely manner. If the proposed model is successful in improving the effectiveness of commercial negotiations, then any costs are likely to be small and will be far outweighed by cost reductions from more efficient negotiations.

Finally, we note that the Commission considers that proponents of an industry-specific negotiate-arbitrate regime have failed to demonstrate why this is necessary, given the availability of the National Access Regime. This matter is addressed in detail in Virgin Australia's initial submission, A4ANZ's submissions and the legal

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[29] For example, restrictions apply to access determinations under Part IIIA of the CCA, including that determination must not prevent an existing user from obtaining a sufficient amount of the service to meet the user's reasonably anticipated requirements (CCA, s 44W(1)(a)). Similar restrictions apply to access determinations in arbitrations under the National Gas Law (NGL, s 216N).

[30] Since the negotiate/arbitrate regime for non-scheme gas pipelines was introduced in 2017, one matter has been referred to arbitration. The arbitration took approximately four months – the matter was referred to the arbitrator on 29 November 2017 and a decision was made on 12 April 2018. The issues in dispute included the value of the asset base to be used in determining tariffs. On 26 April 2018, shortly after the decision was made in the arbitration, the prospective user gave notice to the AER that it wished to enter an access contract in accordance with the arbitrator's decision – under the National Gas Rules, this means that the access provider must enter into a contract with the prospective user on those terms (NGR, r 573(4)). Details regarding this arbitration are available at: <https://www.aer.gov.au/networks-pipelines/non-scheme-pipelines/arbitration-of-access-disputes/final-access-determination-tasmanian-gas-pipeline>.

opinions which accompanied those submissions (including an opinion from Michael O'Bryan QC, who is now a judge of the Federal Court).

The view expressed in these submissions and legal opinions – that the recent changes to the Part IIIA declaration criteria have significantly increased the threshold that must be met for declaration of services supplied by non-vertically integrated infrastructure operators – is supported by the recent draft recommendation of the National Competition Council (**NCC**) to revoke declaration at the Port of Newcastle. The draft recommendation represents a reversal of the position reached by the Full Federal Court in August 2017, based on the previous declaration criteria. In its draft recommendation, the NCC notes that "*the amendments to Part IIIA… represent a significant change to the criteria which apply to the question of whether declaration should be revoked*".[31]

[31] NCC, *Revocation of the declaration of the shipping channel service at the Port of Newcastle: Statement of Preliminary Views*, 19 December 2018, [3.21].