Economic regulation of airport services

Submission by the Virgin Australia Group on the Productivity Commission Issues Paper

PUBLIC

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1. Introduction and Executive Summary

Virgin Australia's position in relation to the economic regulation of airport services is quite simple. Major airports in Australia are natural monopolies. There are no effective substitutes for their services. Under the current regime, Virgin Australia does not consider that there are any effective constraints on the monopoly powers of major airports. The regime is wholly ineffective in this regard. Unless constrained by regulation, these monopolists will continue to increase prices above efficient levels, reduce the quality of the services they offer, or both. This is especially the case where managers of privatised airports have duties to maximise returns to their shareholders.

Virgin Australia also does not consider the current price monitoring regime and declaration provisions to be effective. These mechanisms are intended to provide safeguards that enable concerns about an airport's behaviour to be acted on. However, despite the Australian Competition and Consumer Commission (**ACCC**) continuously reporting on airports' high prices, high profits and poor quality of service, the economic regulation of airports has gone unchanged. In combination, the declaration process in particular is ineffective at constraining airports' market power due to the difficulty in satisfying the amended declaration criteria in addition to the time, cost and uncertainty associated with the process.

Virgin Australia believes that in the absence of an effective constraint on their monopoly power, airports will continue to increase their charges above efficient levels and set terms and conditions for use of their facilities that would not prevail in a competitive market. There is also a risk of service degradation as a result of airports under-investing in capacity or service quality (e.g. bathroom facilities).

This has become an urgent issue as the harm from this conduct extends beyond the impact that it has on airlines and other commercial users of airport services. Increased airport charges and service degradation undoubtedly result in consumer detriment. Since most passengers are price-sensitive, the lack of effective checks and balances in the setting of airport charges will result in an airline either:

1. absorbing the cost due to the intense competition which airlines face; or
2. passing through some or all of the cost but risking reduced demand for air travel and a welfare loss to society as a whole.

It is not simply a question of allocating profits between airports and airlines. Both outcomes also have the potential to result in a decrease in competition between airlines and further consumer harm. The first outcome reduces the ability of airlines to invest and compete effectively due to cost constraints, while the second may lead to a reduction in the number of contestable passengers as a result of airfares increasing.

The cost of airport use is becoming an increasingly urgent issue for Virgin Australia as these charges have risen, and are likely to continue to increase, inappropriately in the absence of any effective constraint on airports.

Virgin Australia remains of the view that a negotiate-arbitrate model is the most effective model for regulating the supply of airport services in Australia. It also considers that this model should be supported by price and costing guidelines and improved monitoring that is effective in controlling airport behaviour.

Virgin Australia agrees that benchmarking measures should be adopted for use in assessing airport operating costs, charges and profitability, so that trends can be monitored.

In this submission Virgin Australia has also made comments on airport car parking and landside access, land transport linkages, air services access to regional New South Wales and competition in jet fuel supply.

As a member of Airlines for Australia and New Zealand (**A4ANZ**), Virgin Australia has had the benefit of reviewing the A4ANZ submission. Virgin Australia fully endorses the arguments and recommendations made in A4ANZ's submission. This submission complements the A4ANZ submission.

2. Recommendations

Recommendation VA1:

Monitoring should be extended to all:

- *Australian capital city airports[1]; and*
- *regional airports that have more than 1,000,000 regular public transport passengers per year.*

Recommendation VA2:

Reporting and monitoring requirements should be enhanced, including to require airports to provide information on the written down economic value of their assets and the methods used to allocate assets to aeronautical and non-aeronautical services.

Recommendation VA3:

Monitoring of airport profits should be based on the written down value of their assets, with this value to be determined using the recovered capital method.

Recommendation VA4:

A new section 192 should be inserted into the Airports Act 1996 (Cth), providing that Division 3 of Part IIIA of the CCA shall apply to certain airport services, as if those services were declared for the purposes of that Division.

Recommendation VA5:

For the purposes of its application to airport services, the arbitration mechanism in Division 3 of Part IIIA of the CCA should be refined to include airport-specific information disclosure obligations, refined criteria for decision-making, and tighter decision timeframes.

Recommendation VA6:

A consumer association / group should be identified or established which can advocate on behalf of consumers in relation to landside services, including car parking.

Recommendation VA7:

Access to dispute resolution mechanisms should be available for these consumer groups, as well as other stakeholders (e.g. taxi industry groups), in the event that a dispute over car parking charges or other landside access charges cannot be resolved with the airport.

Recommendation VA8:

The Sydney Airport Slot Management Scheme should be amended to provide that any available slot may be used to operate a regional service, regardless of the time of day.

Recommendation VA9:

Where on-airport infrastructure is owned by suppliers of jet fuel, the owners of this infrastructure should be subject to an obligation to provide non-discriminatory open access to their facilities.

Recommendation VA10:

Investment plans for on-airport jet fuel supply infrastructure should be developed in consultation with stakeholders.

[1] Any airport that serves a capital city, including the Western Sydney Airport at Badgerys Creek (**Australian Capital City Airports**)

3. Market Power of Australian airports

INFORMATION REQUEST 1

The Commission welcomes suggestions on approaches for identifying which Australian airports have market power in aeronautical services and the extent of their market power.

The Commission is seeking evidence on the extent of market power held by Australian airports, constraints on the exercise of any market power, including whether countervailing power by airlines is sufficient to offset airports' market power. Participants are invited to provide examples of specific airports and airlines, or to discuss these matters in more general terms.

The Commission is seeking evidence on the effects of regulations and regulator behaviour on the conduct of airport operators and airport users, including in relation to an airport's ability and incentive to exercise any market power.

The A4ANZ submission sets out a framework for assessing market power, and for identifying the exercise of market power by Australian airports. The framework set out in the A4ANZ submission is a highly conventional 'structure-conduct-performance' approach. Virgin Australia supports the approach set out in the A4ANZ submission.

As noted by A4ANZ, the structural characteristics of airports are such that they can be presumed to have market power in providing aeronautical services. Airports display natural monopoly features, due to high fixed and sunk costs involved in airport development and network characteristics.

These structural features of airports have facilitated conduct which reflects their market power. This includes pricing above reasonable measures of cost, inefficient investment decisions, and imposition of onerous non-price terms. Some examples of this conduct are set out below in response to Information Request 2.

As to performance, exercises of market power by airports are likely to be reflected in the extent to which they price above economic cost and earn supra-normal profits. Some indication of airports' profitability is provided by the ACCC's annual monitoring reports, although as noted below, there are limitations associated with the ACCC's profitability metrics.[2] To provide a more detailed assessment of airports' performance, A4ANZ has commissioned Frontier Economics to analyse the profitability of the price-monitored airports.[3] The Frontier Economics analysis demonstrates that, regardless of how assets are valued, it is clear that all of the price-monitored airports have been earning returns in excess of their economic costs over the past two decades **[Commercial-in-Confidence]**.

[Commercial-in-Confidence]

Virgin Australia considers that there is no effective constraint on airports' ability to exercise market power. In particular, airports are not constrained by airlines exercising countervailing power. This is because the ability of airlines to exercise countervailing power is severely constrained by the fact that:

- airlines have no credible alternative to seeking airport access; and
- the current regulatory framework is not affecting airports' ability and incentive to exercise market power.

Airlines cannot credibly threaten to withdraw services from most airports, as doing so would typically inflict much greater harm on the airline than the airport – whereas for an airport this would mean the loss of just one airline, for the airline it would have a significant impact on their network reach and the strength of their customer proposition. The importance to any airline of maintaining network reach cannot be overstated. It is common for

[2] The ACCC notes that, as the asset values used to construct its profitability metrics include the effect of pre-2005 revaluations, these profitability metrics will not allow for a meaningful assessment of whether the airports are earning monopoly rents (ACCC, Airport Monitoring Report 2016–17, April 2018, p 189).

[3] Frontier Economics, *The profitability of Australian price monitored airports*, May 2018. Virgin Australia understands that this report has been provided to the Productivity Commission by A4ANZ.

airlines to maintain services on certain routes, even though they are unprofitable, due to the broader importance of that route in the airline's network.

By way of example, Virgin Australia could not credibly threaten to withdraw services from any capital city and many regional airports since doing so would be very damaging to the reach of its domestic and international networks and, therefore, its ability to compete vigorously and effectively against other airlines. Such action by Virgin Australia would also result in a backlash of community sentiment towards the airline, with associated brand damage.

In this context, it is inappropriate to consider an airline's relationship with the particular airport in isolation. Instead, it must be understood in the context of the importance of that airport to the airline's network. An airline's network is particularly important to its ability to compete in the critical corporate travel market. When this is understood, the lack of countervailing power that airlines have is clear.

It is this position that must inform the Productivity Commission's recommendation on what the appropriate regulatory regime should be. It is clear that the current regulatory framework is not affecting airports' ability and incentive to exercise market power. The current price monitoring framework imposes no penalty on airports for exercising market power, and is therefore no deterrent to such behaviour. The shortcomings of the current access regime, and a proposal for improvement, are discussed in more detail later in this submission, but what is clear is that there must be change.

INFORMATION REQUEST 2

The Commission is seeking evidence on airports exercising market power, including:

- *excessive charges for aeronautical services*
- *inefficient investment decisions*
- *inefficient operations*
- *poor service quality*
- *their approach to consultation and negotiation with airport users regarding operational and investment matters, and whether airports' conduct facilitates reaching commercial outcomes.*

The Commission is also seeking evidence on:

- *airlines' approach to negotiations in respect to airports and potential competitors*
- *which parties are affected by airports' exercises of market power*
- *the merits of 'pre-funding' airports' infrastructure investments*
- *the potential costs and benefits of changes to the regulatory regime.*

This section provides some evidence, from Virgin Australia's recent experience negotiating with airports, of the ways in which airports' market power manifests in their conduct. Virgin Australia notes that while the evidence below is of its recent experience, it is reflective of its experience with airports since the move to the price monitoring regime in 2002. The fact that Virgin Australia can provide so many recent examples shows the extent to which that conduct pervades the industry today.

Excessive charges for aeronautical services

Although airports sometimes argue that their charges are based on the economic cost of service provision, calculated using a 'building block' model, in many cases key inputs will be inflated by airports, resulting in excessive charges for aeronautical services.

One area in which airports may seek to inflate inputs is the opening asset base. The airport's opening asset base is often revalued upwards (in some cases considerably so) in order to justify higher charges for

aeronautical services. For example, **[Commercial-in-Confidence]**. Virgin Australia considers that use of these revaluations for aeronautical pricing purposes is generating windfall gains for the airport.

One issue that often arises in relation to asset valuation is the extent to which revaluations undertaken prior to 2006 should be reflected in the asset base used for pricing purposes. While the ACCC is required to rely on asset base values for monitoring purposes which reflect these pre-2006 revaluations, the ACCC has clearly stated that these valuations should not necessarily be regarded as appropriate for any regulatory decision the ACCC may be required to make.[4] The ACCC has also noted that the values used for monitoring purposes are unlikely to be a reliable indicator of the economic value of airport assets, due to the effect of the accounting revaluations.[5] Notwithstanding these clear statements by the ACCC, airports frequently argue that the value of their asset base for pricing purposes should reflect these pre-2006 revaluations.

Issues regarding asset valuation are not limited to the first price setting event after asset handback or privatisation. Rather, these issues continue to influence outcomes at each subsequent price setting event due to a lack of transparency around airports' approach to valuing assets. Specifically, airlines are provided with a stated opening asset value without clear detail on actual investment during the prior term or actual depreciation and asset write-offs making it challenging to gain certainty over the opening asset value.

An additional challenge with the opening asset base (as well as capital investment proposals) is the allocation of assets between aeronautical and non-aeronautical uses / users. There is often a lack of transparency in how airports allocate costs between services and the extent to which common infrastructure costs are being recovered from users of non-aeronautical services. For example, **[Commercial-in-Confidence]**.

Another input that is invariably contentious, and where airports seek to inflate access charges, is the rate of return. In many cases, airports will seek a rate of return that is far in excess of their efficient financing costs, and that does not reflect the degree of risk that they face. For example, in recent negotiations, some airports have sought a pre-tax weighted average cost of capital (**WACC**) of 12% or more. Virgin Australia considers this to be much higher than is necessary to allow an airport to recover its efficient financing costs, particularly in the current low interest rate environment. We note that the allowed rate of return for regulated infrastructure businesses in recent decisions has generally been below 6%.[6]

In some cases airports may refuse to provide a cost model at all, making it impossible for airlines to assess whether the proposed aeronautical charges are appropriate or excessive. This is often the case with regional airports, including some Council-owned ports. In such cases, airlines have no ability to assess the reasonableness of aeronautical charges. Virgin Australia acknowledges that some smaller airports may have limited resources available for cost modelling and engagement with airlines around key inputs, such an asset valuation and the rate of return. Where smaller airports do face these skills / resource constraints, we would support resources being made available to the airport, perhaps through an airport industry association, to enable the airport to more effectively engage with airlines.

Inefficient investment decisions

Virgin Australia faces real challenges in seeking to ensure that the airport investments it is asked to fund are prudent and efficient. Even if airports provide information that they claim supports capital investment underpinning price negotiations, Virgin Australia's experience is that, on numerous occasions, the information is not of the nature necessary to enable it to appropriately assess the efficiency or prudency of the investment, having regard to the need for investment, the scope of the investment or the estimated capital costs. For example, in recent negotiations with **[Commercial-in-Confidence]**, the airport provided two lever arch binders of information supporting its price proposal which did not articulate the drivers for the investment or the scope of the investment and the capital estimates provided were high-level figures which were of little utility.

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[4] ACCC, *Airport prices monitoring and financial reporting guideline: Information Requirements under Part 7 of the Airports Act 1996 and Section 95ZF of the Trade Practices Act 1974*, June 2009, p 25.

[5] ACCC, Airport Monitoring Report 2016–17, April 2018, p 189.

[6] For example, in its November 2017 final decision on the access arrangement for the Victorian gas transmission system, the Australian Energy Regulator allowed a WACC of 5.75% (post-tax, nominal). In a draft decision earlier this year on an access undertaking proposal lodged by Queensland rail network operator Aurizon Network, the Queensland Competition Authority allowed a WACC of 5.41% (post-tax, nominal).

With time sensitive negotiations, airlines often end up funding investments that they have been unable to assess as prudent. Virgin Australia often finds itself in a situation where it has little choice but to enter into an agreement with the airport to fund an investment, even though we have not been provided with clarity around the necessity, scope or cost of the investment, and notwithstanding that the rate of return may be higher than we consider appropriate. This is because, if we do not agree to fund the investment, we face a risk that we constrain our ability to grow, and potentially face higher operating costs to manage congestion at airports.

Virgin Australia is concerned that many of the investment programs that it is asked to fund are in fact not prudent or efficient. Some examples include: **[Commercial-in-Confidence]**

A further challenge for airlines in the price negotiation process is the treatment of capital investment overruns. Airports seek to shift the risk for overruns in capital projects to airlines by including those cost overruns in the opening asset base at the next price review. However, there is very little scope for airlines to challenge the prudency of any excess expenditure after the event and, as a result, airlines are left exposed to the risk that they are paying for imprudent and excessive expenditure.

This capital funding model – which requires airlines to pre-fund capital investments based on limited information, requires airlines to bear the risk of any time and cost overruns, and in many cases does not distinguish between the operational requirements of different carriers – is not conducive to promoting efficient airport investment. To the contrary, this is a model that gives airports the opportunity to make inefficient investments particularly where airports earn high rates of return on any capital expenditure, regardless of its prudency, by absolving the airport of any risks associated with the investment. The examples referred to above demonstrate the risk of inefficiency arising from a model in which airports receive significant benefits from increased expenditure (through higher returns), while airlines bear a disproportionate level of risk.

A further problem with the pre-funding model is that airlines are required to pay for upgraded infrastructure well before it is available for their use. Airlines will often be paying for the cost of upgraded infrastructure through pre-funding arrangements while still using the old, sub-standard, infrastructure. Consequently, there will be a mismatch between the charges being paid by airlines and the level of service that is being delivered by the airport.

Inefficient operations

Virgin Australia rarely sees improvements in operating efficiency reflected in lower aeronautical charges, despite being asked by airports to fund investment directed at delivering such improvements. This suggests that airports either are not making any meaningful efficiency gains, or are not sharing the benefit of such gains with airlines.

For example, **[Commercial-in-Confidence]**.

Pass through of security costs

Airports incur costs relating to security screening measures. However, in the case of some airports, it is unclear to what extent they may be profiting from the provision of these services.

When mandated security screening measures were initially introduced, the Government provided guidance on the recovery of Government Mandated Security Costs. This guidance provided that all costs were to be recovered on a pass-through basis meaning airports were not to profit from the provision of security services. This extended to only recovering the costs associated with resources directly engaged in the provision of security services and not recovering terminal space used in the provision of security services.

Some airports undertake reconciliations at least annually which indicate the extent to which they are recovering their security screening costs. While airlines are unable to challenge the airports' reporting of these costs, the reconciliations at least provide some indication as to whether those airports are profiting from security screening measures.

However, in the case of some smaller airports, no reconciliation of security screening costs and revenue is provided. This means airlines have no assurance that these costs are being directly passed through without a profit margin for the airport. In the case of one airport, a reconciliation was only done as part of recent price negotiations, resulting in a sizeable reduction in security screening fees. This suggests that the airport had been earning a substantial profit on security screening prior to the reconciliation.

Service levels and other non-price terms

Some airports now seek to negotiate and agree service levels with airlines (previously these were not negotiated). While the inclusion of service level metrics is welcome, in practice the implications for failure to meet these service levels present little financial or other risk to the airports. Given that most airports in Australia are natural monopolies, and that airlines must generally maintain their network reach, the result is that airlines have limited recourse where an airport fails to meet the agreed services levels as termination of the contract is not generally viable.

Airports will in some cases seek to impose other non-price terms of access which are particularly onerous on airlines and out of proportion with the legitimate commercial interests of the airport. One example of this is a clause proposed by one airport which gives the airport the right to terminate the agreement should the airline lodge (or support or be in any way involved in) an application for declaration under Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**). For any party to seek the right to terminate an agreement because the other party seeks to exercise a statutory right is inappropriate and contrary to public policy. For a monopolist to do so is a clear abuse of market power.

Parties affected by airports' exercises of market power

The parties affected by airports' exercises of market power go beyond the airlines and other airport tenants and commercial users. Given the central role that airports play in the broader economy, it is clear that the general public are also affected.

Where airports exercise their market power to increase charges above efficient costs, this will lead to either:

- these higher airport charges being passed through to airlines' customers, resulting in charges for air travel that are higher than would be the case if there were effective (or workable) competition in each part of the supply chain; and/or
- airlines being forced to absorb some or all of the effect of higher airport charges, which will have the effect of restricting airlines' ability to invest.

Both outcomes result in harm to consumers. The first outcome means that airfares are higher than they would be in a workably competitive market, which will in turn lead to reduced air travel and economic welfare losses. The second outcome will lead to reduced investment by airlines and may adversely affect service quality and/or conditions for airline competition.

In some cases, Virgin Australia has been forced to absorb increased airport charges due to competitive constraints in markets for air travel, and has had to find productivity improvements and/or forego investment elsewhere in order to offset these cost increases. However Virgin Australia's ability to find offsetting productivity gains is finite, and eventually increases in airport charges will either need to be passed on to consumers and/or will threaten airlines' financial viability.

A4ANZ has commissioned analysis by Frontier Economics which seeks to quantify the economic benefits of constraining airports' ability to exercise market power.[7] Frontier estimates that:

- lower airport charges, resulting from removal of airports' excess profits above their efficient costs, would result in an average annual increase in demand for air services of approximately 2 per cent;
- this increase in demand for air services would result in an increase in consumer surplus of around $650 million per annum, which equates to around $5.9 billion, in NPV terms.

Frontier also notes that this increase in demand for air travel may drive new direct or more frequent connections, which may generate further economic benefits through travel time savings, facilitation of extra trade and foreign investment, and wider economic benefits.

[7] Frontier Economics, *Economic evaluation of an alternative approach to airport regulation: Report prepared for A4ANZ*, September 2018.

Potential costs and benefits of changes to the regulatory regime

The impact of potential changes to the regulatory regime is addressed in the A4ANZ submission and Frontier Economics report.[8] As explained by A4ANZ, the changes it proposes to address airports' market power are not expected to increase administrative or compliance costs. On the contrary, administrative and compliance costs are expected to be lower following changes to the regulatory regime, as any additional costs of compliance will be outweighed by cost savings associated with improved timeliness of negotiation.

The Frontier Economics analysis also demonstrates that any additional costs to airports or the Australian Government associated with administration or compliance with an effective regulatory regime will be vastly outweighed by the broader economic benefits arising from greater regulatory oversight. As noted above, Frontier Economics estimates the economic benefits to be in the order of $5.9 billion, in NPV terms.

Virgin Australia supports the position put forward by A4ANZ in this regard.

INFORMATION REQUEST 3

The Commission welcomes comment on whether it is possible to identify abuse of market power through monitoring of airports' behaviour, whether the monitoring regime should continue, and any alternative approaches to identifying abuses of market power.

The Commission is seeking feedback on the matters it should take into account in its assessment of whether the price and quality of service monitoring regime is fit for the purpose of detecting and deterring abuses of market power.

INFORMATION REQUEST 4

The Commission welcomes comment on whether the information that the ACCC collects is adequate to detect any abuse of market power by airports.

Inquiry participants who consider that the current information collected is not adequate to detect airports' abuse of market power are invited to suggest alternatives to augment or replace this information set. Suggested options should address the question of cost of information, who should pay and why.

The Commission invites comments on the use of analytical approaches, such as data envelopment analysis and stochastic frontier analysis, to interpret indicators of airport performance.

This section responds to Information Requests 3 and 4 together, as they are closely related.

Effective monitoring of airports' behaviour can be used to identify abuses of market power. Specifically, a monitoring regime which allows for an assessment of airports' economic returns against their efficient long-run costs can be used to identify where airports are earning supra-normal profits through an exercise of market power.

The current monitoring regime goes some way to facilitating identification of abuses of market power. For example, under the current monitoring regime the ACCC can monitor trends in airport revenues, expenses and operating profits over time.

However there are several significant limitations of the current monitoring regime.

[8] Frontier Economics, *Economic evaluation of an alternative approach to airport regulation: Report prepared for A4ANZ*, September 2018.

Most obviously, the current monitoring regime is limited to the four largest airports, and therefore cannot identify abuses of market power at other capital city and regional airports. Virgin Australia considers that monitoring should be extended to all:

- Australian Capital City Airports; and
- regional airports that have more than 1,000,000 regular public transport passengers per year.

Virgin Australia's view is that all airports that serve commercial airlines have the ability and incentive to exercise market power, and there is, therefore, a basis on which all such airports could legitimately be made subject to monitoring. However, recognising the resources that would be required for the ACCC to undertake monitoring on this scale, Virgin Australia considers that the approach it advocates for above strikes an appropriate balance.

A further limitation of the current monitoring regime relates to the manner in which profits are reported. While the ACCC is able to report a return on assets for each of the four monitored airports, the asset values used in this calculation are unlikely to be truly representative of the economic value of airport assets. The asset values used in this calculation reflect accounting values, and therefore impound large revaluations undertaken at the airports' discretion prior to 2006.

The ACCC identifies this problem in its most recent monitoring report:[9]

> *In the case of airports, however, the benchmark for efficient long run costs has not been set. Instead, the airports' asset values under monitoring are based on their accounting values rather than their economic value. Importantly, the accounting value of assets may include revaluations that have been undertaken at the airports' discretion and that can distort assessments of airports' performance. For example, in some years, some airports have revalued their assets upwards, which lowers their return on assets. Consequently, the airports' asset values under monitoring do not provide a reliable indicator of the airports' RAB, which is needed to make a meaningful assessment of whether the airports are earning monopoly rents.*

A further issue arises due to the way in which assets are classified by airports as either aeronautical or non-aeronautical assets. As noted above, there is often a lack of transparency in how airports classify assets and allocate costs between aeronautical or non-aeronautical services. Virgin Australia is concerned that some airports may over-allocate asset costs to their aeronautical asset base to inflate aeronautical revenues while imposing commercial rents on non-aeronautical uses that reflect the provision of assets being funded by airlines.

Virgin Australia considers that the monitoring regime could be enhanced so as to allow the ACCC to better identify abuses of market power. Specifically, airports should be required to provide information on the written down economic value of their assets, and should be required to provide greater transparency around the methods used to allocate assets to aeronautical and non-aeronautical services. Greater transparency around written down economic values and cost allocation should allow the ACCC to better assess airports' economic returns against their efficient long-run costs.

Virgin Australia notes that the Australian Energy Regulator (**AER**) has recently published guidelines for reporting of financial information by non-scheme (uncovered) gas pipelines. A key purpose of these guidelines is to facilitate access to services provided by non-scheme pipelines on reasonable terms, by providing prospective users with increased information to reduce the imbalance in bargaining power they can face when negotiating with service providers.[10] Under the guidelines, service providers are required to report the written down economic value of their assets using the recovered capital method (**RCM**). The RCM value reflects the construction cost of the assets and incremental capital expenditure, less the return of capital (amounts recovered from users) and asset disposals.[11] In preparing RCM values, service providers are required to comply with cost allocation principles specified by the AER in the guidelines. Service providers are also

[9] ACCC, Airport Monitoring Report 2016–17, April 2018, p 189.

[10] National Gas Law, s 83; AER, Financial Reporting Guideline for Non-Scheme Pipelines: Explanatory statement, December 2017, p 1.

[11] AER, Financial Reporting Guideline for Non-Scheme Pipelines, December 2017, cl 4.

required to disclose information on pipeline revenue and expenses, and weighted average prices for pipeline access services.

Virgin Australia considers that the AER's reporting guidelines for non-scheme pipelines could be used as a guide for enhancements to the reporting and monitoring regime for airports. In particular, the airport monitoring regime could be enhanced to allow for reporting of the written down economic value of airport assets and the methods used to allocate assets to aeronautical and non-aeronautical services.

Virgin Australia would also support regulatory guidance on the rate of return parameters to be used for the purposes of reporting and monitoring, and to guide commercial negotiations. As noted above, the rate of return is invariably contentious in commercial negotiations between airports and airlines, and this is an area where airports often seek to inflate access charges. Virgin Australia would therefore welcome some regulatory guidance on key WACC parameters and methodologies. The rate of return guideline published by the AER could be used as a model for a WACC guideline for aeronautical services.[12]

Recommendation VA1: monitoring should be extended to all:

- ***Australian Capital City Airports; and***
- ***regional airports that have more than 1,000,000 regular public transport passengers per year.***

Recommendation VA2: reporting and monitoring requirements should be enhanced, including to require airports to provide information on the written down economic value of their assets and the methods used to allocate assets to aeronautical and non-aeronautical services.

Recommendation VA3: monitoring of airport profits should be based on the written down value of their assets, with this value to be determined using the recovered capital method.

INFORMATION REQUEST 5

The Commission is seeking feedback on benchmarks to identify abuses of market power in aeronautical services, including financial benchmarks, operational efficiency benchmarks, service quality benchmarks and others.

In proposing benchmarks, the Commission would appreciate some consideration being given to risk.

Virgin Australia agrees that it can be challenging to set benchmarks which are capable of identifying all abuses of market power. Abuse of market power can manifest in a number of different ways, as demonstrated by the examples referred to above. While benchmark indicators may point to abuse of market power in some cases, they cannot identify all of the ways in which an airport might exercise its market power. For example, where an airport is seeking to impose unduly onerous non-price terms of access in its negotiations with an airline, this is unlikely to be picked up by benchmark metrics.

Additionally, benchmark indicators can in some cases fail to account for the subtleties of particular airport negotiations and/or the circumstances of individual airports. For example:

- A financial benchmark that looks at costs per passenger may indicate that Darwin Airport has a high cost per passenger relative to other similar sized airports and may therefore be seen to indicate a lesser degree of market power at those other airports. However, it would need to be taken into account that Darwin Airport operates 24 hours per day to meet airline demand, despite having relatively low passenger volumes.
- An operational efficiency metric that indicates capacity is available within a facility and therefore the airport has not under-invested would not give consideration to operational realities and the impacts of high asset utilisation rates on efficient airline operations.

[12] AER, Better Regulation: Rate of Return Guideline, December 2013.

- An airport may be earning a return on investment that is reasonable having regard to investment in tangible assets. However, the airport may have over-invested in the scope or standard of the facilities relative to the operational and passenger experience needs of airlines.

Notwithstanding these limitations, Virgin Australia generally supports the use of benchmark indicators of airport profitability. Such indicators, if properly designed, can be useful in providing some indication as to whether airports are earning supra-normal profits.

Importantly however, such indicators need to be designed in a way that will capture airports' economic returns against their *efficient long-run costs*. For reasons outlined above, the current monitoring regime does not allow for reporting of airport profitability in this way. In Virgin Australia's response to Information Request 4, suggested enhancements to the monitoring regime to facilitate better reporting of benchmark profitability indicators are made.

Moreover, while benchmark indicators are likely to be useful, they cannot be solely relied on to identify and address abuses of market power. In addition to benchmark indicators, there needs to be a mechanism for users of airport services to identify and seek remedies for individual cases of abuse of market power by airports. Virgin Australia's recommendation for an arbitration mechanism to complement the enhanced monitoring regime is set out in section 5 below.

INFORMATION REQUEST 6

The Commission is seeking feedback on the way domestic terminal leases are accounted for in the current price and quality of service monitoring regime and any alternative approaches. It also seeks feedback on the costs and benefits of domestic terminal leases.

[Commercial-in-Confidence].

Virgin Australia considers that it is important that terminal leases are treated consistently in the development of any benchmark metrics used in the monitoring and reporting regime. This means that any revenue, costs, passengers and assets associated with leased terminal facilities must either be included in their entirety, or excluded in their entirety, for the purposes of calculating benchmark metrics.

It is not clear to Virgin Australia that terminal leases have been treated consistently in the development of benchmark metrics to date. For example, the most recent ACCC monitoring report indicates that leased terminal facilities are not subject to ACCC prices and quality of service monitoring, but (at least for Brisbane Airport) airport activity data recorded is inclusive of data from leased terminal facilities.[13]

Where terminal leases are not treated consistently, this can create challenges for benchmarking of airports' performance and profitability. For example:

- metrics that examine revenue or costs per passenger may understate the revenue and costs per passenger if revenue / costs from those terminals are excluded from the calculation, yet passenger volumes are included; and
- it remains unclear whether asset values are inclusive or exclusive of the value of leased terminal facilities and therefore metrics on rate of return on tangible assets are potentially understated if earnings exclude leased terminal facilities but tangible asset values include leased terminal facilities.

[13] ACCC, Airport Monitoring Report 2016–17, April 2018, section 3.1.2. The references to leased facilities being excluded from prices and quality of service monitoring are repeated in sections 4.1.2 (with respect to Melbourne) and 5.1.2 (with respect to Perth) however the reference to airport activity data including data from leased terminals is not repeated. The ACCC also reports higher passenger volumes and aircraft movements at Perth Airport (when compared against BITRE data) and higher aircraft movements at Brisbane Airport (again when compared against BITRE data) indicating that the ACCC report includes passenger volumes from all terminal facilities, regardless of whether leased.

Virgin Australia does not propose any major change to the way in which terminal leases are treated. However, it is necessary to ensure that the metrics underpinning ACCC monitoring reports are formed on a consistent basis.

INFORMATION REQUEST 7

The Commission is seeking evidence on the costs of complying with the price and quality of service monitoring regime, and the cost to the Australian Government of administering the regime.

Virgin Australia is not aware of any estimates of the cost associated with administration or compliance with the monitoring regime. Given the light-handed nature of the regime, Virgin Australia expects the costs to the relevant airports would be low.

In our view, the cost of compliance with a monitoring regime should be seen as part of the cost of doing business for any monopoly service providers, but particularly airports given they are the beneficiaries of a shift from heavier-handed price notification regulation to light-handed price monitoring. The trade-off for this benefit should be bearing the cost of compliance with an appropriately rigorous and effective monitoring regime. In all likelihood, any compliance costs associated with the regime are being recovered from airport users as part of fees levied.

Virgin Australia considers that any additional costs to airports or the Australian Government associated with administration or compliance with an effective monitoring regime will be vastly outweighed by the broader benefits arising from greater regulatory oversight. If the monitoring regime (in combination with other mechanisms) can be effective in constraining exercises of market power, the benefit of this constraint is likely to far outweigh any administrative cost.

4. Limitations of the current regulatory regime

INFORMATION REQUEST 8

The Commission is seeking comment on whether the remedies that are available under the current framework for economic regulation facilitate commercially negotiated outcomes in airport operations.

Participants are invited to provide the Commission with legal and other advice they have received in relation to the 2017 changes to Part IIIA of the Competition and Consumer Act.

The Issues Paper identifies three remedies available under the current regulatory framework for addressing abuses of market power by airports:

- governments could impose stricter regulations;
- airport users or prospective users could seek to have infrastructure services declared under Part IIIA of the CCA; and
- the ACCC could use public statements to influence airports and governments about the exercise of market power.

The ongoing exercise of market power to date by a number of airports provides clear evidence that any constraint that the above remedies are intended to impose on airport behaviour has been ineffective. In response to each of the three “remedies”:

- governments have had opportunities to impose stricter regulations, but have not done so despite the outcome of the ACCC’s annual monitoring reports;

- while Virgin Australia and Tigerair have had some success in making declaration applications in the past, for the reasons given below, declaration under Part IIIA of the CCA has not been effective in constraining airports abuse of market power and is likely to be even less effective going forward given the recent amendments to the declaration criteria; and
- the mere "naming and shaming" of airports' abuse of market power by the ACCC has been, and will continue to be, ineffective, unless there is the prospect of some regulatory sanction for this behaviour. Virgin Australia notes that the ACCC has made public statements regarding airports' market power in the past[14], but this appears to have had little effect on the airports' behaviour through its annual monitoring reports. The ACCC has already made a number of statements over a number of years about the exercise of market power by airports and, as noted above, this has not led to any change in airport behaviour or the position of any government.

Governments have in the past pointed to negotiations between airports and airlines producing outcomes as evidence of the efficacy of the current regulatory framework. This view that "any outcome is a good outcome" fails to recognise the significant losses to economic welfare that the imbalance in market power between airports and airlines is producing in commercial negotiations. In Virgin Australia's view, imposition of stricter regulations by government is the most suitable and effective means to address the exercise of market power by airports and ensure benefits to consumers and the broader economy. Our recommendations for enhancements to the regulatory regime, including a new arbitration mechanism to complement an enhanced monitoring regime, are set out in section 5 below.

Part IIIA of the CCA as a potential remedy for abuse of market power by airports

Part IIIA of the CCA in its current form is an ineffective constraint on airports' abuse of their market power. This is principally because the current declaration criteria are directed at addressing circumstances where a vertically integrated monopoly service provider has the ability and incentive to act in a way that is damaging to competition in upstream or downstream markets.[15] As a result, Part IIIA is not well equipped to address circumstances where a non-vertically integrated monopoly service provider is acting in a way that is detrimental to economic welfare, but not materially impacting competition in any upstream or downstream market. Moreover, obtaining declaration under Part IIIA has always been a long, costly and uncertain process for access seekers, and even if declaration can be obtained, the effectiveness of the Part IIIA negotiate-arbitrate model can be limited due to its general nature, broad decision-making criteria, and lack of effective information disclosure mechanisms (see below in relation to these limitations).

Effect of recent changes to the Part IIIA declaration criteria

The effect of recent changes to the Part IIIA declaration criteria is dealt with in detail in the legal advice provided by Gilbert + Tobin in Attachment A, as well as in the A4ANZ submission. Gilbert + Tobin explains 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, such as airports.

Limitations of the Part IIIA negotiate-arbitrate model

There are additional limitations of the current Part IIIA arbitration framework which render it ineffective:

- **No obligation on service providers to provide information –** there are no obligations on service providers, at the negotiation stage, to provide information which may assist users to understand and assess the reasonableness of proposed terms and conditions. The key information asymmetry is likely to be in relation to cost and asset value information, which is likely to be relevant to any assessment of the reasonableness of proposed access prices. This may be contrasted with sector-specific regimes, where access providers are required to publish certain financial and cost information which may be relevant to pricing and/or may be compelled to produce this type of information to regulatory authorities.
- **Criteria to be applied by ACCC in making arbitration determinations is too broad –** Part IIIA of the CCA provides a relatively high level guidance to the ACCC on how it is to determine an access dispute.

[14] For example: 'Airport profits continue to grow', ACCC media release, 26 April 2018.

[15] This issue is addressed in detail in the attached legal advice from Gilbert + Tobin (Attachment A).

Again, this reflects the fact that Part IIIA is a *general* access regime, designed to cater for a wide range of different industries and types of dispute. Consequently, there may be some uncertainty as to the nature of the determination that would be made by the ACCC in any given case. The degree of ACCC discretion in making an access determination, and the range of factors that it must take into account, means that outcomes could vary considerably from case to case. A further source of uncertainty is the fact that only one access determination has ever been made by the ACCC under Part IIIA. This determination was in a very different context – relating to the supply of water and sewerage services by a vertically integrated business with regulated retail prices set on a geographically uniform basis – and therefore provides limited guidance for how an access dispute in relation to airport charges might be determined. The determination in that case was for 'retail-minus' pricing, a pricing methodology that could not be applied in the airport context. A sector-specific regime could provide more guidance around how access determinations are to be made. Consequently, there can be greater certainty under these regimes as to the terms and conditions that would be determined if a dispute is referred to arbitration. This can in turn provide clearer parameters for commercial negotiations.

- **Potential for significant delays –** under Part IIIA there is the potential for significant delays in resolution of disputes. It can in some cases take considerable time for the ACCC to gather information and make determinations. While there is a time limit of 180 days for the ACCC to determine an access dispute under Part IIIA, it may 'stop the clock' in a range of circumstances, including where the ACCC requests information or submissions from the parties. Further exemplifying the ineffectiveness of Part IIIA, such delays may come after:
    - the parties conducted commercial negotiations for a period of 6 – 12 months or more;
    - the airline prepared and filed a declaration application, including taking the time to prepare all of the information which the National Competition Council (**NCC**) seeks at the outset, such as expert reports on declaration criteria (a) and (b) in particular;
    - the airline then participates in the NCC process which takes at least 180 days from the day the NCC receives the application;
    - the airline then has to wait 60 days for the designated Minister to make a decision;
    - regardless of the Minister's decision, there is then the potential for the matter to be heard by the Australian Competition Tribunal, Full Federal Court and High Court. For Glencore, this process took nearly three years and would have taken even longer had Port of Newcastle's application for special leave to the High Court been successful; and
    - if the service is ultimately declared and the airline wishes to seek arbitration, the airline then has to prepare its notification of an access dispute.

  Altogether, there is real potential for this process to take 4 – 5 years if the process plays out in full. The process for Virgin Blue to gain access to airside services at Sydney Airport took almost 5 years from the application for declaration in October 2002, to resolution of the terms of access to the airside services in May 2007.

In section 5, we outline an alternative model for regulatory oversight of airports which is designed to overcome a number of these key limitations. The proposed model (like Part IIIA) relies on a negotiate-arbitrate framework for resolving disputes. However, enhancements have been made in the proposed sector-specific regime to provide for effective information disclosure, clearer decision-making criteria and timely resolution of disputes.

5. Regulation to promote efficient operation, use of, and investment in, airport infrastructure

INFORMATION REQUEST 9

The Commission is seeking evidence that changes to the current 'light handed' approach to airport regulation are necessary. Participants are invited to suggest alternative approaches, the mechanisms to put such approaches into practice and the potential benefits and costs of the changes.

Virgin Australia considers that the current price-monitoring regime has not been effective in preventing major airports from abusing their market power, including by earning aeronautical revenues significantly above their efficient costs. The impact of this goes beyond a mere wealth transfer from airline shareholders to airport shareholders. As explained in section 3 above, charges above efficient levels result in reduced passenger numbers and welfare losses to society as a whole.

Virgin Australia considers that the regulatory regime should be designed to prevent airports from raising charges significantly above efficient levels, while retaining maximum flexibility to allow airports and airlines to negotiate and agree on efficient and competitive terms and conditions for the use of airports' facilities.

To achieve this objective, Virgin Australia considers that the approach to airport regulation needs to be amended in two respects:

- firstly, the regime for monitoring of airports' behaviour needs to be enhanced to better facilitate detection of abuses of market power; and
- secondly, an arbitration mechanism should be available to complement the enhanced monitoring regime.

In section 3 of this submission Virgin Australia has identified improvements that could be made to the current monitoring regime, including expansion of its scope beyond the four largest airports, and enhanced reporting requirements (see response to Information Requests 3 and 4, and recommendations VA1, VA2 and VA3).

In the remainder of this section, we discuss the A4ANZ proposal for an arbitration mechanism to complement the enhanced monitoring regime.

Arbitration mechanism

The A4ANZ submission proposes that the arbitration mechanism in Division 3 of Part IIIA of the CCA be made available for resolution of disputes in relation to airport services. Virgin Australia supports this proposal and adds the comments below in relation to specific aspects of its implementation.

Key elements of the A4ANZ proposal are as follows:

- It is proposed that a new section 192 of the *Airports Act 1996* (Cth) be inserted, providing that Division 3 of Part IIIA of the CCA shall apply to certain airport services, as if those service were declared for the purposes of that Division.
- Once the service is declared, any user of the service, or the service provider, may seek ACCC arbitration of access disputes. The ACCC would adopt "final offer arbitration". The final offer chosen by the arbitrator binds the parties to the dispute and in most applications, forms the basis of an agreement between them for the provision of services. With the arbitrator selecting one party's final position (or parts of each party's final position) without the possibility of compromise or variation, the risk of arbitration is raised and, therefore, increases the incentive for the parties to bargain and negotiate on reasonable terms prior to the regulator's involvement.

A4ANZ notes that there are several means by which the Part IIIA arbitration mechanism could be applied to airport services, including:

1 The new section 192 could deem all airport services, as defined in regulation 7.02A of the Airports Regulations, to be declared services for the purposes of Division 3 of Part IIIA.

2 The new section 192 could deem only those airport services in respect of which an airport operator has substantial market power to be declared services for the purposes of Division 3 of Part IIIA.

3 A relevant Minister or administrative body (such as the ACCC) could be empowered to determine that one or more airport services are declared services for the purposes of Division 3 of Part IIIA.

While each of these options is worthy of consideration, and each has certain attributes, Virgin Australia considers that the last option is preferable. This option provides all stakeholders with the greatest degree of certainty in relation to the availability of arbitration to resolve disputes.

Virgin Australia considers that where an appropriate form of arbitration is available to resolve disputes, this will provide a credible threat of intervention to constrain the exercise of market power by airports during negotiations.

Virgin Australia also considers that an arbitration mechanism is a regulatory solution that is appropriately targeted and proportionate to the problem of airports exercising market power in negotiations with airlines. Virgin Australia's strong preference is to commercially negotiate agreements with airports and, therefore, it would not support a heavy-handed *ex ante* form of regulatory intervention. In Virgin Australia's view, any regulatory solution should maintain the primacy of commercial negotiation and aim to support (not displace) such negotiations. The problem is that, to date, negotiations with airports have rarely been conducted on a truly commercial basis. There has been a severe imbalance in bargaining power between airports and airlines, due in part to the market power that airports possess in supplying aeronautical and related services, but also due in part to exposure that airlines face in negotiations given their need to maintain network reach (as discussed in section 3 above).

Virgin Australia therefore contends that an incentive is needed to encourage airports to negotiate commercially in relation to the supply of these services. Virgin Australia believes that the best way to retain the efficiency and flexibility of commercial negotiations while providing an incentive for airports to engage in genuine commercial negotiations is to provide for a 'circuit breaker' where a party would have the option of referring a matter to independent arbitration if the parties could not agree commercially.

The potential benefits of an arbitration mechanism are illustrated by past experience. Where an arbitration mechanism has been made available – in relation to the declared Airside Service at Sydney Airport – Virgin Australia was able to quickly and commercially resolve its dispute with the airport once the threat of arbitration became available.

There are further overseas examples that show that parties in a regulatory framework with access to such mechanisms are willing and able to negotiate settlements to the extent that they are allowed to do so. In his article, *Australian airport regulation: exploring the frontier*, Professor Stephen Littlechild has referred to examples of this in the context of the energy sectors in the United States, in relation to pipeline line toll cases in Canada, and in relation to the aviation industry in the United Kingdom. Professor Littlechild has also referred to the latest EU Airport Charges Directive which establishes a procedure under which there is regular consultation between an airport and its users about airport charges. Under this procedure, either party may seek the intervention of an independent supervisory authority in the event of a disagreement.[16]

While Virgin Australia strongly supports the availability of an arbitration mechanism, it regards the Part IIIA mechanism as suffering from a number of limitations, as outlined in section 5 above. Virgin Australia therefore considers that, in its application to airport services, the general arbitration framework in Part IIIA should be refined and augmented in the following respects:

- **Airport-specific information disclosure obligations.** Virgin Australia considers that there should be obligations on airports to publish information required by airlines to effectively engage with the airport in relation to terms of access and/or obligations on airports to provide certain information if requested by access seekers. This may include information on the value of assets used to provide access services, historic expenditure information and standing offer prices. Due to its general nature, Part IIIA does not include specific obligations around information disclosure – this has previously been identified as a

[16] Stephen Littlechild, 'Australian airport regulation: exploring the frontier' (2011), University of Cambridge, 22-24.

limitation of the Part IIIA regime, but recommended reforms to address it have not been implemented.[17] In most sector-specific access regimes, there are obligations to disclose information around costs and pricing periodically, and/or obligations to provide such information to access seekers during negotiations. For example, under the regime that applies to non-scheme gas pipelines, service providers are required to periodically report on weighted average prices, asset values, cost allocation methods, and other financial / cost information as specified by the regulator.[18] Additionally, service providers may be required to provide specific information as requested by an access seeker during negotiations.[19]

- **Refined criteria for decision-making.** Again due its general nature, Part IIIA does not include specific criteria or rules for determination of disputes – rather, Part IIIA requires the ACCC to take into account a range of general factors in making a determination.[20] Virgin Australia suggests that any mechanism for resolving disputes in relation to airport access should incorporate more specific criteria or rules to be applied in making access determinations (e.g. rules requiring that access prices reflect the cost of providing access, with costs to be assessed on a particular basis).
- **Decision timeframes.** There is the potential for considerable delays in resolving access disputes under Part IIIA. As noted above, while there is a time limit of 180 days for the ACCC to determine an access dispute under Part IIIA, it may 'stop the clock' in a range of circumstances, including where the ACCC requests information or submissions from the parties.[21] It may be appropriate for tighter timeframes to be imposed for determining access disputes relating to airport services, compared to the timeframes which usually apply to disputes under Division 3 of Part IIIA. Virgin Australia notes that, under the new arbitration framework for non-scheme gas pipelines, most disputes are to be resolved within 50 business days.[22]

These augmentations could be made as modifications to the Part IIIA framework for the purposes of its application to airports.

Recommendation VA4: a new section 192 should be inserted into the Airports Act 1996 (Cth), providing that Division 3 of Part IIIA of the CCA shall apply to certain airport services, as if those services were declared for the purposes of that Division.

Recommendation VA5: for the purposes of its application to airport services, the arbitration mechanism in Division 3 of Part IIIA of the CCA should be refined to include airport-specific information disclosure obligations, refined criteria for decision-making, and tighter decision timeframes.

[17] For example, in its 2001 review of the national access regime, the Productivity Commission considered that mandatory information disclosure should be included in Part IIIA to address information asymmetries and expedite access negotiations for declared services. However this recommendation was not adopted by the Commonwealth Government (Productivity Commission, *Review of the National Access Regime Inquiry Report*, 28 September 2001, pp 205-213). While the Government agreed in principle with the recommendation, it was considered too difficult to include information disclosure requirements in the general access regime (Government response to Productivity Commission report on the national access regime, p 8).

[18] AER, Financial Reporting Guideline for Non-Scheme Pipelines, December 2017.

[19] National Gas Rules, rule 562.

[20] *Competition and Consumer Act 2010* (Cth), s 44X.

[21] *Competition and Consumer Act 2010* (Cth), s 44XA.

[22] National Gas Rules, rule 572.

6. Car parking and landside access

INFORMATION REQUEST 10

The Commission is seeking evidence on the extent of market power held by Australian airports in on-airport car parking and landside access services and constraints on the abuse of market power.

Virgin Australia has a strong interest in ensuring that car parking and other landside services are delivered efficiently. Car parking and other landside services are complementary to air travel, and for many Virgin Australia customers (particularly leisure travellers), the cost of these services has the potential to influence their decision to travel. Efficient pricing and delivery of car parking and other landside services is therefore important for ensuring efficient use of airports and air travel.

Virgin Australia has serious concerns regarding the market power held and exercised by Australian airports in on-airport car parking and landside access services.

As the Issues Paper notes, airports are monopoly providers of on-airport car parking and of landside access to terminal forecourt areas. Virgin Australia considers that the airports hold substantial market power in respect of these services and that this market power is largely unconstrained, resulting in airports abusing their market power and charging excessive prices for these services to the detriment of consumers.

On-airport car parking

The limited competitive constraint that airports face for parking is reflected in the very high profit margins reported by the ACCC for on-airport car parking at the four monitored airports. The ACCC reports operating profit margins of over 50% at each of the four monitored airports. At Sydney Airport, operating profits are over 70%.[23]

Virgin Australia notes that, in some cases, an airport's market power may be constrained to a limited extent by the alternatives available to consumers, such as off-airport parking, taxis and public transport options. However, Virgin Australia considers that consumer choice and the viability of these alternatives is impacted by both their price and functionality. Not all alternatives are viable for all consumers. For example, for some consumers travel by public transport may take an unreasonable period of time, mobility issues could make public transport not feasible, or the cost of taxi transport or ride share service may be prohibitively expensive.

Virgin Australia is not aware of any entity that negotiates car parking charges with airports on behalf of consumers – rather, these charges are determined by airports with a view to maximising profits. Therefore, as travel to the airport is a necessary part of the passenger journey, car parking fees are only constrained by the costs of alternative transport options available to the consumer and the functionality and convenience of those alternatives. When car parking is prohibitively expensive, this will have a detrimental effect and economic consequences on how consumers use airports, airlines and air travel. This is especially likely to be the case for low-cost carriers, such as Tigerair, where consumers are even more likely to consider the affordability of the total cost of travel, including to the airport, prior to booking.

It is also important to note that the availability of alternatives is typically controlled by the airport. For example the availability of on-airport, non-terminal car parking, or the access conditions for off-airport car park operators requiring terminal forecourt access to collect and drop off customers, will be within the airport's control.

Accordingly, although alternatives to airport-controlled on-airport parking may exist, the extent they offer any constraint on an airport's market power is limited as the airport is able to dampen any constraint through the conditions of access required by the rival operator.

Landside access

Further to on-airport parking, airports are also monopoly providers of access to terminal forecourt areas.

[23] ACCC, Airport Monitoring Report 2016–17, April 2018, p 43.

As is the case for setting aeronautical fees, an airport's market power is constrained only by any potential countervailing bargaining power of the users of those services. However, as users of landside access services have no alternative but to seek airport access, they are unlikely to have any real countervailing power. Taxis, ride-sharing providers, rental vehicles, bus operators, shuttle buses for off-airport car parking and other transport providers all require the ability to drop off and collect customers directly from the terminal forecourt and must negotiate access terms with the airport.

In the same way airlines do not have the option to use an alternative facility, Virgin Australia anticipates that the users of other landside access services do not have the option to use other facilities and therefore, similarly do not have countervailing power to constrain the airports' substantial market power and constrain their abuse of that power. Airports alone have the power to control who may access these areas and the conditions of access, free from effective competitive constraint.

Abuse of market power by airports

In addition to the level of profit earned by airports from car parking and landside services, a key concern for Virgin Australia is the lack of transparency in the airports' overall pricing frameworks. Specifically, airports will classify infrastructure and services as either "aeronautical" or "non-aeronautical", which may include allocating a percentage of an asset to each category. However there is little or no transparency around airports' overall allocation of asset costs as between aeronautical and non-aeronautical services.

Virgin Australia is concerned that, due to the lack of overall transparency, airports have the ability to over-allocate or inappropriately allocate assets to the aeronautical asset base while still having regard to the cost of those assets when setting terms and conditions of landside access and other non-aeronautical facilities. This can result in "double-dipping", whereby costs may be allocated to both aeronautical and non-aeronautical services, resulting in duplication of recovery by the airport.

[Commercial-in-Confidence]

Virgin Australia notes that similar outcomes can occur with respect to the allocation of road costs between airlines, car park operators, taxi operators, freight operators and retail tenants. **[Commercial-in-Confidence]**

INFORMATION REQUEST 11

The Commission is seeking comment on the effectiveness of the price and quality of service monitoring regime for on-airport car parking and landside access. The Commission would welcome participant views on:

- *whether data that the ACCC collects are suitable for identifying the abuse of market power*
- *evidence that could be used to determine whether airport operators are abusing market power in car parking and landside access*
- *whether regulators have adequate remedies to deal with abuses of market power*
- *the costs of complying with the price and quality of service monitoring regime*
- *alternative approaches to detecting and deterring potential abuses of market power in on-airport car parking and landside access.*

Virgin Australia considers effective price monitoring of on-airport car parking and landside access to be important, given the ability of airports to exercise market power and how this may impact on an individual's decision to travel.

In relation to car parking, Virgin Australia notes that not only are airports monopoly service providers, but there is also no negotiation as the fees are simply imposed by the airports on consumers. There is no negotiating counterparty that could have any bargaining power, let alone sufficient countervailing power to counteract the airports' market power. Consumers lack any bargaining power in respect of car parking fees yet are bearing the brunt of on-airport car parking fees and paying excessive charges without any representation.

In terms of the effectiveness of the price and quality of service monitoring regime for on-airport car parking and landside access, Virgin Australia addresses the Commission's specific points below.

1. Whether data that the ACCC collects is suitable for identifying the abuse of market power

   Without specific details as to the exact nature of the data collected by the ACCC, it is difficult for Virgin Australia to assess whether that data is suitable for identifying abuses of market power. Virgin Australia acknowledges that for the ACCC to undertake this analysis it would require a considerable amount of information and data.

   That said, as the ACCC's reporting demonstrates, the data gathered is sufficient for assessing revenue and profit margins and identifying that airports are generating excessive returns from car parking services and landside access. Therefore, the data is at least sufficient to indicate potential market abuses which would warrant further investigation.

   For reasons outlined above, Virgin Australia considers that the ACCC's data collection and reporting should also be directed at providing greater transparency around allocation of airport costs as between aeronautical and non-aeronautical services.

2. Evidence that could be used to determine whether airport operators are abusing market power in car parking and landside access:

   As with any analysis of abuse of market power, considerable information and data would be required. In addition to information about why a particular decision was made and what consideration was given to the effects of that decision, financial information is likely to be required from both the airports and the other market participants. Financial data could be used to examine, for example, whether the airports are imposing excessive prices and/or generating excessive returns. It would be more difficult for the ACCC to assess whether there has been any abuse of market power when considering airports' financial data alone. With evidence from market participants, an effective comparison and analysis can be undertaken, for example to understand whether an airport is operating efficiently and competitively.

   As explained in response to Information Request 5, Virgin Australia also considers that financial benchmarks may provide an indication as to whether an airport is abusing its market power. However, the details of specific incidents may need to be considered in determining whether market power has been abused.

3. Whether regulators have adequate remedies to deal with abuses of market power:

   There is currently no adequate remedy for dealing with abuses of market power where such abuses are able to be detected. There is no penalty that can be imposed on airports for excessive pricing, nor is there a readily available regulatory solution to prevent excessive pricing continuing into the future.

   As discussed in section 4, the ACCC's powers under the price and quality of service monitoring regime are limited to reporting on historical outcomes and, to date, have not been effective in constraining airports from earning excessive returns in respect of their aeronautical facilities. As such, Virgin Australia does not anticipate that the existing powers under the price and quality of service monitoring regime are any more effective in dealing with abuses of market power in the car parking and landside access space compared to aeronautical services.

   The Issues Paper notes that the ACCC can issue public statements and seek to influence airports' behaviour through these public statements. However, as also discussed in section 4, this is as far as the ACCC's powers extend under the current monitoring regime – all the ACCC can do is "name and shame" those airports that are abusing their market power, in the hope that this will influence their behaviour. Virgin Australia notes that the ACCC has made public statements regarding airports' market power in the past[24], but this appears to have had little effect on the airports' behaviour.

   Further, as explained in response to Information Requests 8 and 9 above, the framework in place for having a service declared under Part IIIA of the CCA is not adequate for dealing with abuse of monopoly

[24] For example: 'Airport profits continue to grow', ACCC media release, 26 April 2018.

power by airports. The structure of the declaration criteria is such that the mere existence of market power (and abuse of that market power by the service provider) may not be sufficient for a service to be declared. As explained above and in the attached legal advice from Gilbert + Tobin, recent changes to the declaration criteria have made it significantly more difficult for users of non-vertically integrated infrastructure to have services declared, even where it is clear that market power is being abused. Moreover, even where the declaration criteria can be satisfied, obtaining declaration under Part IIIA can be a long, costly and uncertain process. Virgin Australia anticipates that a declaration would be even more unattainable for car park and landside access users, with cost, time and uncertainty barriers for these service providers.

As to the third potential remedy identified in the Issues Paper – imposition of stricter regulations by governments – this is precisely what Virgin Australia considers should now occur. The ACCC's monitoring reports have identified abuse of market power by airports. It is now up to governments to address this through stricter regulation.

4. <u>The costs of complying with the price and quality of service monitoring regime:</u>

Virgin Australia considers the costs of regulatory compliance to be a standard, expected cost of doing business, particularly for monopoly infrastructure providers. This is true across all industries.

With respect to car parking and landside access, the costs of regulatory compliance are unlikely to be prohibitive for airports, particularly given the high levels of revenue being achieved from these services and the fact that they form a smaller proportion of an airport's revenue compared with aeronautical revenue.

In any event, Virgin Australia notes that, at least for aeronautical fees, these costs are included in the operating costs incurred by the airport and therefore effectively passed on to and funded by airlines. Accordingly, it cannot be ruled out that the costs of regulatory compliance for car parking and landside access would not be passed on.

5. <u>Alternative approaches to detecting and deterring potential abuses of market power in an on-airport car parking and landside access:</u>

In respect of on-airport car parking, Virgin Australia considers that the following approaches may assist in the detection and deterrence:

- The ACCC's price monitoring powers should be enhanced to allow for better detection of airports' abuse of monopoly power. As discussed above, the ACCC monitoring regime could be enhanced through changes to the way in which asset values are to be reported by airports and greater transparency around cost allocation.
- A consumer association / group should be identified or established which can advocate on behalf of consumers. This group should be specifically tasked with representing consumers in negotiations regarding car parking charges. Ultimately, consumers are paying the cost of the excessive charges without any voice or representation.
- Access to dispute resolution mechanisms should be available for these consumer groups, as well as other stakeholders (e.g. taxi industry groups), in the event that a dispute over car parking charges or other landside access charges cannot be resolved with the airport. The dispute resolution mechanism for car parking and other landside services could be similar to the proposed mechanism for resolving disputes in relation to access to aeronautical services and facilities – i.e. access to arbitration (see section 5, and recommendations VA4 and VA5 above).

Improved monitoring and extension of the negotiate-arbitrate model to landside access services would create a more level playing field between the monopolist airports and those service providers / users who do not currently have countervailing bargaining power against the airports. The ability to have their access dispute more readily arbitrated by the ACCC would be more effective at deterring the abuse of market power by the airports than the status quo.

Recommendation VA6: a consumer association / group should be identified or established which can advocate on behalf of consumers in relation to landside services, including car parking.

Recommendation VA7: access to dispute resolution mechanisms should be available for these consumer groups, as well as other stakeholders (e.g. taxi industry groups), in the event that a dispute over car parking charges or other landside access charges cannot be resolved with the airport.

7. Land transport linkages

INFORMATION REQUEST 12

The Commission is seeking comment on the existing arrangements for the planning and operation of land transport linkages including evidence of problems and suggestions for alternative approaches or improvements to existing arrangements.

As the Tourism and Transport Forum (**TTF**) noted in its 2014 report on accessing Australia's airports, airports "*are vital transport hubs operating in multi-layered local, state, national and international transport networks. Ensuring ease of access to our airports is therefore critical for the end-to-end value chain*".[25]

Virgin Australia considers that effective planning, development and operation of land transport linkages is vital to the efficient use of airports and that a holistic approach needs to be taken to the planning of land transport arrangements. As the TTF identified in its report (at page 7):

> "*land transport access to our major airports is problematic. Planning and investment in land transport to airports has not kept pace with the rapid growth in airport passenger traffic over the last decade*."

That said, from Virgin Australia's perspective, its involvement in the existing arrangements depends on how such land transport linkages are intended to be financed.

To the extent that the cost of land transport linkages is being passed on to airlines, Virgin Australia undertakes a detailed assessment of the need for the proposed linkages it is being asked to fund. In this assessment, Virgin Australia will also consider alternatives to the proposed option and scope of options to ensure that the proposal reflects the most efficient and effective way of achieving any stated aims and delivering the necessary capacity.

Where costs are not passed on, such that airlines are not asked to fund the investment, Virgin Australia and other airlines may not be given the opportunity to comment on the investment proposal. Airports' five-yearly master plans, which cover land transport linkages, are subject to public consultation with the opportunity for interested parties to comment prior to approval.

Nevertheless, Virgin Australia is unaware of the extent to which airports are engaging effectively with local and State road operators, public transport providers and other stakeholders. With respect to alternative approaches or improvements to the existing arrangements, Virgin Australia considers that benefit would be gained from seeking to ensure comprehensive transport planning with engagement from a range of stakeholders. Particular consideration should be given to local and State roads and public transport options, in collaboration with local and State Government.

In this regard, Virgin Australia notes the TTF's findings from its report (at page 8):

> *"A lack of long-term sustained investment in transport services to airports and a lack of integrated planning have been the precursors to the current state of affairs. There is little ownership of responsibility by government and little recognition of the role that transport to our major airports plays in wider city and national transport networks. With airports a federal responsibility and urban transport a state/territory responsibility, critical transport infrastructure to airports has all too often fallen through the cracks. The awareness of the importance of supporting growing and changing demand for land*

[25] *Accessing Our Airports: Integrating City Transport Planning with Growing Air Services Demand*, 2014, p 7.

transport to airports, as a key facilitator of national economic growth, has not been adequately embraced by state and territory governments.

… [I]mproved consultation by airports and land transport planning authorities will not in itself guarantee enhancements to land transport systems to airports. Rather, it will be critical that state and territory government land transport agencies recognise the rapid growth in land transport access demand for airports and prioritise resources to addressing the existing problems."

Virgin Australia does not have specific recommendations for enhanced regulation in this regard.

8. Air services to access regional New South Wales

INFORMATION REQUEST 13

The Commission is seeking information on:

- *the objectives of the arrangements for providing access to Sydney Airport for airlines servicing regional destinations within New South Wales*
- *the effects of the regional ring fence and price cap regime on the availability and price of regional air services into and out of Sydney Airport*
- *the effects of the arrangements on interstate and international flights, and on Sydney Airport*
- *alternatives to the current arrangements.*

Sydney Kingsford Smith Airport (**KSA**) is the only Australian airport that has a legislated slot management system. The Sydney Airport Slot Management Scheme (the **Scheme**) was introduced in 1998 to facilitate the hourly cap on aircraft movements under the *Sydney Airport Demand Management Act 1997* (Cth) (**SADM**). Slots were allocated to airlines under the Scheme principally on the basis of historical precedence, i.e. slot use in 1997.

The Scheme contains arrangements that designate particular slots as 'permanent regional service series' (**PRSS**) for the operation of services between Sydney and other points in New South Wales (**NSW**). The policy objective underpinning these 'regional ring fencing' arrangements is a desire to ensure that access by regional communities to services and facilities in Sydney was maintained and to support connections with domestic and international flights at KSA.

In 2001, further modifications were made by the Government to the 'regional ring fencing' aspects of the Scheme ahead of the privatisation of KSA. These included measures designed to prevent the gradual rescheduling of regional services to less convenient timings, encourage the use of larger aircraft by regional operators and limit increases in charges for aeronautical services and facilities for regional air services.

Notwithstanding these provisions, the Scheme does not provide adequate protection against the conversion of slots for the operation of regional services to slots for the operation of interstate or international (i.e. non-regional) services over time. While the Scheme allows PRSS slots to be converted to slots for the use of non-regional services when unsubscribed after a period of two equivalent scheduling seasons, it does not permit the use of slots allocated for the operation of non-regional services to be used for the operation of regional services in the peak periods, defined under the Scheme as 6am to 11am and 3pm to 8pm on weekdays. In combination, therefore, the mechanisms of the Scheme have the effect of reducing the total pool of slots available for regional services over time, particularly at the times of the day when demand for these services is highest.

It is important to distinguish between the peak period defined under the Scheme, i.e. ten of the 17 hours that KSA is operational each day, and the peak period from an airline and consumer perspective, which is approximately 7am to 9am and 5pm to 7pm. Access to slots in these periods is critical for the operation of convenient and viable regional air services, as it enables day trips to be undertaken by travellers based in both Sydney and regional communities. A service that departs from or arrives at KSA at 10am or 11am and returns at 3pm or 4pm does not permit this, and consequently is much less attractive to many residents of and visitors

to regional communities. Given the similar sector length of many regional routes in NSW, timings in these windows also facilitate schedules that support efficient aircraft utilisation and a competitive level of frequency for regional airlines.

In the periods from 7am to 9am and 5pm to 7pm on weekdays, there are 42 fewer PRSS slots each week at KSA in Northern Summer 2018 compared with Northern Summer 2001, as a result of slot conversions and retiming of services into the less convenient hours of the defined peak period. This has been the case for a number of years.

As there are essentially no unutilised PRSS slots in these periods, no meaningful expansion of intrastate services can occur. New entrants and airlines without an established portfolio of PRSS slots are therefore prevented from bringing competition to NSW regional routes.

Virgin Australia would like to expand services and/or improve schedules on some of its existing regional routes, as well as commence services to additional airports in NSW. However, the remaining PRSS slots available for allocation fall outside the peak periods and/or do not support the operation of commercially viable services. While Virgin Australia invested in a fleet of dedicated regional aircraft in late 2011, it has had limited opportunities to access PRSS slots in peak periods – that is, the current situation does not reflect relinquishment of such slots through conversion for the operation of non-regional flights.

While 'regional ring fencing' is often cited as a safeguard for NSW intrastate services, the protections it offers should not be overstated. The unintended consequences of the Slot Management Scheme highlighted above are serving to inhibit the growth of sustainable air services to destinations in regional NSW, restrict scope for growth in competition, and risk the erosion of regional operations at KSA over time. It is therefore reasonable to conclude that the arrangements are not working in the best interests of regional passengers.

In order to address this, Virgin Australia recommends that the Scheme is amended to provide that any available slot may be used to operate a regional service, regardless of the time of day. The operation of regional services utilising such slots would not, however, result in the creation of additional PRSS slots under the Scheme, balancing the interests of regional and non-regional operations, and the productivity of KSA. While the proposed changes would not be expected to result in conversion of slots by airlines on a significant scale, the flexibility to do so would facilitate important competitive benefits for travellers to/from regional NSW.

Virgin Australia notes that Western Sydney Airport is expected to be operational in around 2026. While this will offer opportunities for development of intrastate air services, the primary sources of demand for the foreseeable future will continue to be point-to-point travel between regional NSW and central Sydney and connections to domestic and international services at KSA.

Against this background, Virgin Australia believes it would be in the long-term interests of regional NSW for the 'regional ring fencing' mechanisms in the KSA Slot Management Scheme to be adjusted to provide sufficient flexibility to promote the policy objectives underpinning them.

Virgin Australia notes the statements made by Sydney Airport quoted on page 23 of the Issues Paper which are drawn from its submission to the current Senate Inquiry into the operation, regulation and funding of air route service delivery to rural, regional and remote communities. In addition to suggesting that a domestic airline may use any slot allocated to a non-regional service to operate a regional service (which is not the case as per subsection 11(2) of the Scheme and inconsistent with the material in the preceding paragraphs on page 23) Sydney Airport claims that the Scheme acts as a disincentive to airlines from converting slots as it puts at risk an airline's historical rights to slots which are transferred in such a manner. This is incorrect, with the relevant sections of the Scheme (in particular section 10) providing that historical precedence is not affected by whether a slot series is used to operate a regional or non-regional service.

Recommendation VA8: the Sydney Airport Slot Management Scheme should be amended to provide that any available slot may be used to operate a regional service, regardless of the time of day.

9. Competition in jet fuel supply

INFORMATION REQUEST 14

The Commission is seeking evidence on the extent of competition in the jet fuel market, the effects of the current level of competition on airlines, passengers, air freight users and other parties, and options for addressing any lack of competition in the market for jet fuel.

Virgin Australia has had the benefit of reading the BARA submission in relation to competition in jet fuel supply, and we agree with its key points and recommendations.

In particular, Virgin Australia supports the following outcomes to bolster competition for jet fuel supply at major Australian airports:

1. an agreed infrastructure plan, developed in consultation between airports, fuel companies and airlines, for the provision of the on-airport storage and distribution facilities, including facilities for into-plane service providers;
2. mandated, non-discriminatory access to the on-airport storage and distribution facilities; and
3. periodic jet fuel demand-supply studies at Sydney, Melbourne, Brisbane and Perth airports, sponsored by the federal and state governments.

As indicated by BARA, competition in supply of jet fuel at many Australian airports is weak. At some airports, there is only a single supplier of jet fuel. Lower levels of effective competition has led to sub-optimal outcomes in markets for the supply of jet fuel at airports, in terms of the reliability, efficiency and pricing of jet fuel supply.

Virgin Australia considers the lower competition is at least partly due to ownership and control structures for jet fuel supply infrastructure at Australian airports. As the Issues Paper identifies, at the major Australian airports, jet fuel supply infrastructure (on-airport fuel storage and distribution facilities) is owned by the suppliers of jet fuel – i.e. there is a high degree of integration between ownership of on-airport infrastructure and supply of jet fuel. This integration between infrastructure ownership and jet fuel supply can give rise to significant physical and commercial barriers to entry. In particular, jet fuel suppliers' ownership of on-airport infrastructure can give rise to an incentive and ability to foreclose or restrict competition in the supply of jet fuel.

Jet fuel suppliers' ownership of on-airport infrastructure may also give rise to an incentive to under-invest in infrastructure capacity, since restricting capacity is likely to lead to higher prices for jet fuel, and prevent competition. By way of example, in recent years, Melbourne Airport has seen fuel shortages due to high passenger growth coupled with insufficient infrastructure on-airport and off-airport, failing to ensure that supply meets demand. Under the current model, fuel suppliers have benefited from under-investment in fuel infrastructure through higher prices for supplied jet fuel, to the detriment of their customers.

Potential new jet fuel importers are faced with considerable uncertainty and risk about their ability to gain access to the jet fuel infrastructure supply chain. This uncertainty around obtaining secure and coordinated access to the jet fuel infrastructure supply chains is a clear deterrent to new market entrants and increased competition.

[Commercial-in-Confidence]

At international airports outside of Australia, there are a greater number of jet fuel suppliers and more diverse and robust supply chains, resulting in more competitive markets. In these overseas markets, the ownership and control of on-airport infrastructure for fuel storage and distribution of jet fuel is typically held by independent parties, rather than the fuel suppliers themselves. Consequently, infrastructure investments are balanced towards fuel demand from airlines for passenger growth. In these more competitive overseas markets there are also options for into-plane fuel operations where supplied by the ground handlers.

Off-airport infrastructure, including off-airport fuel storage facilities and pipeline infrastructure for transporting the fuel to the airport, is also an important part of the fuel supply chain. Access to two or more pipelines for

international airports is highly desirable from both a competition perspective and for security of supply, in light of the risks of a single pipeline outage (for example, at Perth and Melbourne Airports). The lack of competition at this level of the supply chain further exacerbates the issues in the market, as without investment in new infrastructure the existing infrastructure will reach maximum capacity, preventing new suppliers from entering the market. Potential new suppliers require access to the full supply chain on- and off-airport to be able to supply jet fuel to airlines at the airport. Without new entry, the jet fuel market will remain uncompetitive and airlines will continue to face significant costs.

From a customer's perspective, the lack of competition in the jet fuel market affects the market in which Virgin Australia operates as well as having a detrimental effect ultimately on consumers. As the Issues Paper highlights, jet fuel represents around a third of an airline's operating costs and therefore increased jet fuel prices can have a significant effect on airlines' costs. Weak competition for jet fuel supply leads to higher prices being paid by the airlines for this critical input, and ultimately higher ticket prices for our passengers.

Virgin Australia considers that, where on-airport infrastructure is owned by suppliers of jet fuel, the owners of this infrastructure should be subject to an obligation to provide non-discriminatory open access to their facilities. An open access regime for on-airport infrastructure should help to reduce barriers to effective competition in jet fuel supply.

Additionally, as suggested by BARA, infrastructure investment plans should be developed in consultation with stakeholders, including airport operators, jet fuel suppliers, ground handlers and airlines. This should reduce the risk of under-investment in on-airport infrastructure capacity.

Recommendation VA9: where on-airport infrastructure is owned by suppliers of jet fuel, the owners of this infrastructure should be subject to an obligation to provide non-discriminatory open access to their facilities.

Recommendation VA10: investment plans for on-airport jet fuel supply infrastructure should be developed in consultation with stakeholders.

Attachment A: Gilbert + Tobin advice

Memorandum of advice

11 September 2018

To	Virgin Australia Airlines Pty Ltd, Virgin Australia Regional Airlines Pty Ltd and Tigerair Airways Australia Pty Ltd
From	Charles Coorey, Geoff Petersen and Zoe Hodgins, Gilbert + Tobin
Subject	**Changes to criteria for declaration under Part IIIA of the Competition and Consumer Act 2010 (Cth)**

1 Summary

1.1 As part of its inquiry into economic regulation of airport services, the Productivity Commission (**Commission**) has invited inquiry participants to provide the Commission with legal advice they have received on the implications of recent changes to the national access regime in Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**). The criteria for declaration of services under Part IIIA of the CCA have recently been amended. You have asked us to advise as to the likely effect of these changes on outcomes of applications for declaration in respect of non-vertically integrated infrastructure, such as airports.

1.2 In preparing this advice we have had the benefit of reviewing Johnson Winter & Slattery's advice on this topic to Airlines for Australia & New Zealand (**A4ANZ**) (of which Virgin Australia and Tigerair are members) dated 5 September 2018 (**JWS Advice**). We agree with the view expressed in the JWS Advice that:

(a) the recent changes to the Part IIIA declaration criteria have increased the legal threshold that must be met for declaration, particularly in relation to non-vertically integrated infrastructure such as airports; and

(b) the combined effect of these amendments, together with the existing significant cost, time and uncertainty associated with the 'declaration process', is that, to the extent that the threat of declaration may have constrained airports' market power, the credibility of this threat has deteriorated.

1.3 This advice focuses on the first of these points and explains why we consider 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, such as airports.

1.4 In summary:

(a) The change to criterion (a) means that it is likely to be much more difficult for users of non-vertically integrated infrastructure to obtain declaration. The key reasons for this are:

(i) Immediately prior to the change, criterion (a) had been interpreted by the Full Federal Court[1] as requiring that access to the relevant service (as compared to no access or a restricted form of access) promote competition in a dependent market.

[1] *Port of Newcastle Operations Pty Ltd v Australian Competition Tribunal* [2017] FCAFC 124 (***Port of Newcastle***). The decision in *Port of Newcastle* was consistent with the earlier decision of the Court in *Sydney Airport Corporation Limited v Australian Competition Tribunal* [2006] FCAFC 146 (***Sydney Airport***).

(ii) The approach of the Full Federal Court to the former criterion (a) may be contrasted with the approach that had been adopted by the National Competition Council (**NCC**) in several cases, including in its consideration of applications for declaration of services at the Port of Newcastle[2] and Sydney Airport[3]. The approach of the NCC had been to compare a scenario in which there is access on reasonable terms with the status quo.

(iii) It had been observed, including by the Court in *Port of Newcastle*, that the approach favoured by the Full Federal Court created a lower hurdle for a declaration applicant, compared to the alternative construction. This was clearly demonstrated by the differing conclusions reached by the NCC and Full Federal Court in relation to the Sydney Airport and Port of Newcastle declaration applications – the NCC concluded in both cases that criterion (a) was not satisfied, however on the Full Federal Court's approach this criterion was clearly satisfied.

(iv) In our view, the effect of the recent amendment to criterion (a) is to dispense with the prevailing approach (as set out by the Full Federal Court in *Port of Newcastle*), and reinstate the approach that had been adopted by the NCC. This is clearly indicated by the text of the amendment and the explanatory materials.

(v) By reinstating a with / without declaration test, and dispensing with the with / without access test, the amendment is likely to significantly increase the hurdle for users of non-vertically integrated infrastructure seeking declaration. Previously an applicant was likely to satisfy criterion (a) if it could be demonstrated that access to the relevant service was required in order for users to be able to compete in dependent markets – a surmountable hurdle for users of most critical infrastructure, such as a major airport, and one that had more potential to pose a credible threat of constraint on the abuse of market power by service providers. It now needs to be demonstrated that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service, would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service.

(b) While we consider the change to criterion (a) to be the most significant, in terms of its likely effect on the outcome of any application for declaration in respect of non-vertically-integrated infrastructure, we note that the amendments to criteria (b) and (d) also present additional challenges for applicants and are likely to further increase the overall threshold for declaration. In particular:

(i) We consider that the change to a 'natural monopoly' test under criterion (b) means that this criterion will now be more difficult to satisfy, at least in a practical sense.

(ii) The changes to criterion (d) are expressly intended to raise the hurdle for declaration, and in our view are likely to do so. Whereas previously the NCC / Minister only needed to be satisfied that access would not be contrary to the public interest, now the NCC / Minister needs to be positively satisfied that declaration (not just access) would promote the public interest.

1.5 These points are discussed in detail below.

[2] National Competition Council, *Declaration of the shipping channel service at the Port of Newcastle: Final recommendation*, 2 November 2015 (**Port of Newcastle Recommendation**).

[3] National Competition Council, *Application by Virgin Blue for Declaration of Airside Services at Sydney Airport: Final Recommendation*, November 2003 (**Sydney Airport Recommendation**).

2 Part IIIA declaration

2.1 Part IIIA of the CCA provides for a general national access regime, under which users and prospective users can seek to have infrastructure services declared, giving them a right to negotiate access to the service and a right to have any subsequent dispute on access terms arbitrated by the Australian Competition and Consumer Commission (**ACCC**). The regime is intended to promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets. It was first introduced in 1995 as part of the National Competition Policy, which brought in broad ranging reforms to enhance productivity and growth in the Australian economy.

2.2 The regime has been reviewed three times since its enactment: through inquiries undertaken by the Commission in 2001 and 2013, and then by the Review into Competition Policy (**Harper Review**) in 2015. Both the 2013 and 2015 reviews examined the application of the declaration criteria and whether the operation of the criteria was achieving the objectives of the regime.

2.3 In its 2013 review of the national access regime, the Commission recommended a number of changes to the Part IIIA declaration criteria, and the Commission's recommendations were mostly endorsed in the Harper Review.

2.4 As a result of these recommendations, the Commonwealth Government decided to amend the declaration criteria as of 6 November 2017 via the *Competition and Consumer Amendment (Competition Policy Review) Act 2017* (Cth).

2.5 Following the recent amendments, the Part IIIA declaration criteria are as follows:[4]

(a) that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service; and

(b) that the facility that is used (or will be used) to provide the service could meet the total foreseeable demand in the market:

(i) over the period for which the service would be declared; and

(ii) at the least cost compared to any 2 or more facilities (which could include the first-mentioned facility); and

(c) that the facility is of national significance, having regard to:

(i) the size of the facility; or

(ii) the importance of the facility to constitutional trade or commerce; or

(iii) the importance of the facility to the national economy; and

(d) that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote the public interest.

[4] CCA, s 44CA.

2.6 The designated Minister cannot declare a service unless he or she is satisfied of all of the declaration criteria for the service, and the NCC cannot recommend declaration unless it is so satisfied.[5]

2.7 The recent changes to the declaration criteria included amendments to criteria (a) and (b), as discussed in detail below. The public interest criterion (formerly criterion (f)) was also amended and renumbered as criterion (d). Criterion (c) (the national significance criterion) was not amended.

2.8 We consider the substance of the recent changes to criteria (a), (b) and (d), and the effect of those changes, in detail below. As explained, we consider that the recent changes to the Part IIIA declaration criteria have materially increased the threshold for declaration of services supplied by non-vertically integrated infrastructure operators, such as airports.

3 Effect of changes to criterion (a)

3.1 Prior to the most recent amendments to the Part IIIA criteria, criterion (a) was:

> "*that access (or increased access) to the service, would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service*".

3.2 Following the most recent amendments, criterion (a) is now:

> "*that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service*".

3.3 To illustrate the significance of this change, it is necessary to briefly review the way in which the former criterion (a) has been interpreted over time.

Competing interpretations of the former criterion (a)

3.4 There has been considerable debate regarding the test to be applied under criterion (a). This criterion clearly contemplates a comparison of the likely state of competition in two different states of the world. However, there have been differing views on what the two relevant states of the world should be for the purposes of this comparison.

3.5 There have been three approaches taken under previous versions of criterion (a):

(a) A comparison of competition in a world where there is access to the service compared to competition in a world where there is no access at all (or alternatively a comparison between worlds in which there is increased access to the service, compared with a restricted right to access). In the analysis that follows we refer to this as **Option 1**, or the with / without access test.

(b) A comparison of competition in a world where there is access to the service on reasonable terms and conditions compared to competition in a world where there is access other than on reasonable terms and conditions. We refer to this as **Option 2**.

[5] CCA, ss 44G, 44H(4).

(c) A comparison of competition in a world where there is access on reasonable terms through declaration compared to the status quo (i.e. the current commercial or regulatory arrangements). We refer to this as **Option 3** or the with / without declaration test.

3.6 In the discussion below, we describe this as the 'counterfactual' element of criterion (a). The prevailing approach to this counterfactual test has moved around over the years.

The approach adopted prior to the decision of the Full Federal Court in *Sydney Airport*

3.7 Prior to 2006, the prevailing view had been to adopt Option 3 – comparing competition under access on reasonable terms as a result of declaration with the status quo.

3.8 This approach to criterion (a) was articulated by the NCC, in its consideration of Virgin Blue's application for declaration of airside services at Sydney Airport, as follows:[6]

> *"The Council must consider whether access (or increased access) facilitated by declaration of the Airside Service would promote a more competitive environment in the Domestic Passenger Market and in the other possible dependent markets identified in paragraph 6.98. In doing so, the Council compares the future competitive environment in the dependent markets if the Airside Service was declared against that if the service was not declared."*

3.9 In that case, based on the above interpretation of criterion (a), the NCC concluded that this criterion was not satisfied in respect of the relevant airside services at Sydney Airport. The NCC concluded that, while Sydney Airport had an ability and incentive to exercise market power, any exercise of market power was not likely to have a material adverse effect on competition in any relevant dependent markets.[7]

The decision of the Full Federal Court in *Sydney Airport*

3.10 The decision of the Minister (based on the NCC's recommendation) to not declare airside services at Sydney Airport was appealed to the Australian Competition Tribunal (**Tribunal**), and the Tribunal's decision to set aside the Minister's decision was appealed to the Full Federal Court.

3.11 On appeal, the Full Federal Court adopted a different interpretation of criterion (a) to that adopted by the NCC. The Court adopted an interpretation more akin to Option 1 – comparing competition in a world with access (or increased access) with competition in a world without access (or with only a restricted right to access). The Court explained its approach to criterion (a) as follows:[8]

> "*We agree with the submission of Virgin that the relevant enquiry in s 44H(4)(a) is the comparison between access and no access and limited access and increased access. That is what the words say. They do not say that it is necessary to examine whether declaration of the service would promote competition; they say "access or increased access … would promote competition."*
>
> *…Taking into account the context and background, we think that in this part of s 44H, the word "access" is being used in its ordinary English sense. Virgin is correct in its submission that all s 44H(4)(a) requires is a comparison of the future state of competition*

[6] Sydney Airport Recommendation, [6.99].

[7] Sydney Airport Recommendation, [6.272], [6.273], [6.278].

[8] *Sydney Airport*, [81], [83].

in the dependent market with a right or ability to use service and the future state of competition in the dependent market without any right or ability or with a restricted right or ability to use the service."

3.12 The Court's different approach to the interpretation of criterion (a) led it to a conclusion that was diametrically opposed to the NCC's. The Court accepted that, on its alternative construction, criterion (a) was satisfied in respect of the relevant airside services at Sydney Airport.[9] This conclusion was said to be 'easily reached' because:

(a) Sydney Airport is a natural monopoly and Sydney Airport Corporation Limited (**SACL**)exerts monopoly power;

(b) the airside service is a necessary input for effective competition in the dependent market;

(c) neither Bankstown nor Richmond Airport could provide the service; and

(d) the parent company of SACL had the first right of refusal to build and operate any second major airport within 100 kilometres of the Sydney CBD.

3.13 It was also noted that there was no real debate among the experts before the Tribunal that, given the strategic nature of Sydney as Australia's largest city and a significant gateway to international air travel, access to Sydney Airport is essential to compete in the domestic air passenger market.

NCC Port of Newcastle Recommendation

3.14 Criterion (a) has been applied more recently in the context of an application by Glencore for declaration of shipping channel access services at the Port of Newcastle.

3.15 In the Port of Newcastle Recommendation, the NCC again applied an approach to criterion (a) in line with Option 3. While acknowledging the decision of the Full Federal Court in *Sydney Airport*, the NCC considered that it was justified in maintaining this approach in light of more recent case law (including the decision of the Full Federal Court in the Pilbara rail access matters) and amendments to criterion (a) since the *Sydney Airport* decision. The NCC considered that, in light of these developments, in assessing the effect of access (or increased access) on competition, it was permitted to consider the effect of access (or increased access) on such reasonable terms and conditions as may be determined in an arbitration under Part IIIA of the CCA.[10]

3.16 Based on this interpretation of criterion (a), the NCC concluded that this criterion was not satisfied in respect of the shipping channel access service. The NCC noted that key dependent markets were already competitive, and that a change to the terms of access for the shipping channel service was unlikely to materially affect conditions for competition in those markets.

3.17 In the Port of Newcastle Recommendation, the NCC also made a number of comments regarding its approach to the declaration criteria (as they then were) which are pertinent to the present matter. The NCC noted:[11]

"The declaration criteria, in particular criteria (a) and (b), limit the ambit of the National Access Regime to situations where services are provided by facilities that are

[9] *Sydney Airport*, [91]-[92].

[10] Port of Newcastle Recommendation, [4.76].

[11] Port of Newcastle Recommendation, [3.17]-[3.19].

uneconomic to duplicate and where the price or other terms and conditions of access are such that competition is restricted in a market other than the market for the infrastructure service.

A classic example of such a situation is where a vertically integrated business controls a monopoly facility as well as competing in a dependent market which is otherwise open to competition. Where such a business tries to advantage its position in the dependent market through how it prices access to the monopoly facility, regulatory intervention may be necessary to promote competition in the dependent market.

Here there is no material vertical integration between PNO's operation of the Port of Newcastle and other activities in the Hunter Valley coal chain. In its submission responding to the draft recommendation, Glencore raised the possibility of vertical integration issues arising due to China Merchant Group's half interest in PNO and its involvement in shipping activities. In response to the notice from the Council, PNO provided further details of the relationship between PNO and any shipping interests of China Merchants Group (PNO Response to Notice, pp. 3-5 and paragraph 4.35 below). This information identified only very limited and indirect links. It seems highly unlikely that these interests would give rise to concerns of the kind mentioned in paragraph 3.18. It is difficult to envisage a scenario in which it would be in the interests of China Merchants to allow higher port charges for vessels linked to other of its interests in order to advantage a business in which it has a half interest. Nor has any material been provided to the Council to show the circumstances in which such a scenario would be likely to arise. Equally it is unlikely that Hastings Funds Management, the other co-owner of PNO, would allow any subsidy to interests linked to China Merchants. Furthermore, there are likely to be significant prudential and legal barriers to engaging in such arrangements."

3.18 In that case the infrastructure owner (Port of Newcastle Operations, or **PNO**) was not vertically integrated, and this appears to be a key reason for the NCC's conclusion that criterion (a) was not satisfied. In light of the comments above it seems likely that, had PNO been vertically integrated, the NCC would have found criterion (a) to have been satisfied.

Decision of the Full Federal Court in *Port of Newcastle*

3.19 The decision of the Minister (based on the NCC's recommendation) not to declare the shipping channel service at the Port of Newcastle was appealed to the Tribunal, and the Tribunal's decision to set aside the Minister's decision was appealed to the Full Federal Court.

3.20 On appeal, both the Tribunal and the Full Federal Court adopted a different interpretation of criterion (a) to that adopted by the NCC. As in *Sydney Airport*, the Court adopted an interpretation more akin to Option 1 above – comparing competition in a world with access (or increased access) with competition in a world without access (or with only a restricted right to access).

3.21 In *Port of Newcastle*, the Full Federal Court stated:[12]

"*Criterion (a) does call for a comparison between two circumstances in order to assess whether one of those will promote a material increase in competition in a dependent market. The difficulty with the construction advanced by PNO … is to state what those two circumstances are and to avoid re-entering the territory of a future with a declaration and a future without a declaration. With respect we think the Full Court's construction,*

[12] *Port of Newcastle*, [139].

which involves a comparison between access and no access and increased access and restricted access, is the more natural one."

3.22 The Full Court also expressly rejected an interpretation of criterion (a) which called for a comparison of a world with declaration and the status quo (Option 3 above). In *Port of Newcastle*, the Full Court agreed with the earlier decision in *Sydney Airport* on this point:[13]

> *"In our respectful opinion, the Full Court in Sydney Airport Full Court was correct to reject the proposition that access meant a declaration under Part IIIA. That is not the ordinary meaning of the word and as the Full Court said, and as the Act expressly provides, a declaration under Part IIIA does not necessarily lead to access for anyone. It can be seen how reading the word "access" as meaning a declaration under Part IIIA readily leads to the conclusion that existing and likely future usage is to be taken into account. The comparison becomes one between a future with a declaration and a future without a declaration and the latter readily invites a consideration of likely future access where things remain the same."*

3.23 As in *Sydney Airport*, the different approaches taken to the interpretation of criterion (a) led to diametrically opposed conclusions. In contrast to the NCC's conclusion (referred to above), the Tribunal concluded that it was 'straightforward' that criterion (a) was satisfied in the case of the shipping channel service. The Tribunal explained that the service providing access to the shipping lanes was a natural monopoly and PNO exerted monopoly power; the service was a necessary input for effective competition in the dependent coal export market as there was no practical and realistically commercial alternative; so access to the service was essential to compete in the coal export market.[14] The Tribunal's decision was upheld by the Full Federal Court.[15]

Implications of the different formulations for access to services supplied by non-vertically integrated infrastructure operators

3.24 As can be seen from the discussion above, the approach taken to the former criterion (a) had major implications for the outcome of any declaration application, particularly where the owner / operator of the relevant infrastructure was not vertically integrated (as was the case in both the Sydney Airport matter and the Port of Newcastle matter).

3.25 Under the approach favoured by the Full Federal Court in *Sydney Airport* and *Port of Newcastle* (Option 1), an applicant was likely to satisfy criterion (a) if it could be demonstrated that access to the relevant service was required in order for users to be able to compete in dependent markets. This was a surmountable threshold in the case of airside services at Sydney Airport, since some form of access to these services was considered necessary for an airline to compete in markets for air travel (i.e. without any form of access to Sydney Airport, airlines could not compete in any market which involves transport of passengers into / out of Sydney). Similarly in the Port of Newcastle matter, some form of access to the port was necessary for the Hunter Valley coal producers to compete in the coal export market.

3.26 However under the approach favoured by the NCC in those two cases (Option 3), criterion (a) would not be satisfied simply on the basis that access was required in order to facilitate competition. Rather, under the NCC formulation of criterion (a), it needed to be demonstrated that a change in the terms of access as a result of declaration would improve conditions for competition in a dependent market. As noted above, the NCC could not be satisfied on this test

[13] *Port of Newcastle*, [138].

[14] *Application by Glencore Coal Pty Ltd* [2016] ACompT 6, [113].

[15] *Port of Newcastle*.

in respect of airside services at Sydney Airport or the shipping channel service at the Port of Newcastle.

3.27 On the other hand, the approach taken to the former criterion (a) was less critical to applications for declaration in respect of vertically integrated bottleneck infrastructure. In those cases, criterion (a) was likely to be satisfied on both the NCC approach and the Full Federal Court approach, for reasons set out by the NCC in the Port of Newcastle Recommendation (see paragraph 3.17 above).[16]

Background to the recent amendments to criterion (a)

3.28 The most recent amendments to criterion (a) were originally recommended by the Commission in its 2013 review of the national access regime.[17]

3.29 In its review, the Commission indicated that it strongly favoured an approach to criterion (a) in line with Option 3 above, focused on a comparison between declaration and the status quo. The Commission explained in its final report:[18]

> "*The Commission considers that it is appropriate that criterion (a) – reframed to consider the effect of declaration rather than access – allows for declaration where the prevailing terms and conditions of access are* ***so poor*** *that they disrupt competition in another market*." (emphasis added)

3.30 As indicated in its final report, the Commission considered that *Sydney Airport* lowered the hurdle for declaration.[19] Confirming the pre-2006 / NCC view, and seeking to raise the hurdle, it considered that criterion (a) should be amended so that it is only satisfied where access to a service on reasonable terms and conditions through declaration would promote a material increase in competition in a dependent market. Consistent with this, the Commission expressed the view that criterion (a) should not be satisfied where there is already effective competition in dependent markets because declaration would be unlikely to promote a material increase in competition.

3.31 The Commission's recommendations in respect of criterion (a) were subsequently adopted by the Harper Review, for essentially similar reasons.[20] Agreeing with the Commission's recommendation to amend criterion (a) to focus on the effect of declaration, the Harper Panel were critical of setting the threshold for access too low, stating:[21]

> "… *the Panel … considers that criterion (a) sets too low a threshold for declaration. The burdens of access regulation should not be imposed on the operations of a facility unless access is expected to produce efficiency gains from competition that are significant*".

3.32 The Harper Panel also specifically considered that the scope of the National Access Regime should "*be confined to ensure its use is limited to exceptional cases*".[22]

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[16] Port of Newcastle Recommendation, [3.17]-[3.19].

[17] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013.

[18] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013.

[19] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013, p 171.

[20] Competition Policy Review, Final Report, March 2015, p 433.

[21] Competition Policy Review, Final Report, March 2015, p 73.

[22] Competition Policy Review, Final Report, March 2015, p 431.

3.33 The amendments made to criterion (a) therefore reflected recommendations made in the Commission report (from 2013) as adopted by the Harper Panel in 2015.

Effect of the 2017 amendments

3.34 As noted above, following the amendments made to the declaration criteria in late 2017, criterion (a) now states (amendments underlined):

> "*that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the service*".

3.35 In our view, the effect of this amendment is to force a change to the approach to criterion (a) from that adopted by the Full Federal Court in *Port of Newcastle* (Option 1), to the approach that prevailed prior to 2006 and which has been adopted by the NCC in several cases (Option 3). We take this view for two reasons:

(a) The language of criterion (a) (unlike the previous language) now explicitly directs attention to the effect of *declaration* on the terms of access. Criterion (a), in its terms, is no longer simply directed at a comparison of conditions for competition with and without access (or increased access) to the service. Rather, criterion (a) now requires an assessment of the effect on competition in dependent markets of there being access on reasonable terms as a result of declaration.

(b) The explanatory materials behind this amendment indicate that it was intended that there be an analysis of the likely terms of access if the service were to be declared, compared to the prevailing terms of access (i.e. the status quo). These secondary materials do not support a comparison of access on reasonable terms with no access. As noted above, the Commission report indicates that the reframed criterion allows for declaration "*where the prevailing terms and conditions of access are so poor that they disrupt competition in another market*."

3.36 Consequently, the re-framed criterion (a) effectively requires an applicant to demonstrate that there is scope for a material increase in competition (or improvement to the conditions for competition), relative to the status quo, that would flow from access on reasonable terms as a result of declaration.

3.37 As has been demonstrated above, changing the approach to criterion (a) from a with / without access analysis (Option 1) to a with / without declaration analysis (Option 3) is likely to have major implications for the outcome of any declaration application, particularly where the owner / operator of the relevant infrastructure was not vertically integrated. Indeed, in the case of both Sydney Airport and the Port of Newcastle, opposite conclusions were reached under these two approaches. As was noted by the Full Federal Court in *Port of Newcastle*, its approach to criterion (a) created a lower hurdle for a declaration applicant, compared to the alternative constructions advanced in that case.[23]

Potential for application of the new criterion (a) to non-vertically integrated infrastructure

3.38 The current criterion (a) is more likely to be satisfied where an application relates to services supplied using vertically integrated bottleneck infrastructure. This is because, in general, a vertically integrated owner / operator of bottleneck infrastructure is likely to have the ability and *incentive* to exercise market power in a way that is damaging to competition in upstream or

[23] *Port of Newcastle*, [141].

downstream markets, by either refusing access and/or discriminating against competitors in the provision of access. Access on reasonable terms as a result of declaration can address the service provider's ability to act in this way, and therefore promote competition.

3.39 On the other hand, while a non-vertically integrated owner/operator of monopoly infrastructure will still be in a position to exercise market power, it is less clear that any exercise of market power will necessarily be damaging to competition in upstream or downstream markets. A non-vertically integrated owner / operator may not face the same incentives to refuse access and/or discriminate against competitors in the provision of access. This is not to say that actions by a non-vertically integrated monopoly service provider could *never* be damaging to upstream or downstream competition. However, it is less clear that this would occur in the absence of vertical integration. As noted above, this was essentially the conclusion of the NCC in its Sydney Airport Recommendation – the NCC concluded that, while Sydney Airport had an ability and incentive to exercise market power, any exercise of market power was not likely to have a material adverse effect on competition in any relevant dependent markets.[24]

3.40 Consequently, it has been observed that this criterion is not fit for the purpose of addressing situations where there is scope for abuse of market power (or monopoly power) by a non-vertically integrated service provider.[25] For example, the ACCC has stated (even prior to the recent amendments) that criterion (a) has been the most difficult to satisfy for applicants seeking access to non-vertically integrated infrastructure. The ACCC has noted that:[26]

> "*The hurdle posed by criterion (a) has, in effect, allowed … operators to engage in monopoly pricing in a relatively unconstrained manner*".

3.41 Importantly, the ACCC explains that, in cases where the service provider is not vertically integrated, abuse of market power / monopoly power is still likely to damage economic efficiency, but not through diminution of competition. Hence, in these cases, there will be an economic problem that is not addressed by the criteria in Part IIIA of the CCA, as recently amended.

3.42 While this has always been a recognised feature of the Part IIIA regime, the recent amendment to criterion (a) has highlighted and entrenched this as an issue. Whereas under the Full Federal Court interpretation of the previous criterion (a) the criterion could more easily be satisfied even for non-vertically integrated infrastructure (as illustrated by the *Sydney Airport* and *Port of Newcastle* decisions), the recent amendment means that the approach must now be one which makes it far more difficult to satisfy the criterion in respect of non-vertically integrated infrastructure.

Practical difficulties under amended criterion (a) are significant

3.43 Further, there can be no doubt that any access seeker attempting to satisfy criterion (a) would face substantially higher practical difficulties under the amended criteria than previously. This is principally because of the addition of the words "*on reasonable terms and conditions, as a result of a declaration of the service*" which can be said to require an assessment of the reasonableness of the current terms and conditions, compared with those that would result from an arbitration conducted post-declaration. This is consistent with the position of the NCC in the Port of Newcastle Recommendation where, as noted in paragraph 3.15 above, the NCC considered that it was permitted to consider the effect of access (or increased access) on such

[24] Sydney Airport Recommendation, [6.272], [6.273], [6.278].

[25] ACCC inquiry into the east coast gas market, April 2016, p 130.

[26] ACCC inquiry into the east coast gas market, April 2016, p 130.

reasonable terms and conditions as may be determined in an arbitration under Part IIIA of the CCA.

3.44 In effect, this is likely to require an assessment at the declaration stage of whether the existing terms and conditions of access are reasonable, and if not, what are the 'reasonable terms and conditions' that would be determined in arbitration. Under the interpretation of criterion (a) adopted by the Full Federal Court in *Port of Newcastle*, such an analysis would not have been required until a matter came to arbitration, since the analysis at the declaration stage would have been based on a simpler comparison of the worlds with and without access. However under the amended criterion (a), the more complex analysis of what are 'reasonable' terms and conditions of access will be required at the declaration stage.

3.45 The difficulties in conducting this analysis have already been recognised by the Full Federal Court in *Port of Newcastle,* as noted in paragraph 3.21 above**,** and would exist in any other matter.

4 Changes to criterion (b)

4.1 Prior to the most recent amendments to the declaration criteria, criterion (b) required that:

> *"…it would be uneconomical for anyone to develop another facility to provide the service"*

4.2 Following the amendments, criterion (b) now requires that:

> *"the facility that is used (or will be used) to provide the service could meet the total foreseeable demand in the market:*
>
> *(i) over the period for which the service would be declared; and*
>
> *(ii) at the least cost compared to any 2 or more facilities (which could include the first-mentioned facility)"*

Competing interpretations of the former criterion (b)

4.3 As with criterion (a), the interpretation of the former criterion (b) had been the subject of debate. There were three possible interpretations of the former criterion (b), as discussed by the High Court in *Pilbara*:[27]

(a) **Natural monopoly test**. As explained by the High Court, this test involves an assessment of "whether the facility in question can provide society's reasonably foreseeable demand for the relevant service at a lower total cost than if it were to be met by providing two or more facilities".[28]

(b) **Net social benefit test**. This test would seek to decide whether it is "uneconomical" to duplicate a facility by taking account not only of productive costs and benefits but also considerations of allocative efficiency and dynamic efficiency.[29]

[27] *Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal* [2012] 246 CLR 379 (***Pilbara***).

[28] *Pilbara*, [79].

[29] *Pilbara*, [80].

(c) **Private profitability test**. This test directs attention to whether any person (including the incumbent operator of the facility to which access is sought) would find it profitable to establish a second or competing facility.[30]

4.4 The prevailing approach since the High Court's decision in *Pilbara* was to adopt the 'private profitability' test. The majority view of the High Court was that criterion (b) should involve a consideration of whether it would be profitable for any current or potential market participant to develop an alternative facility – if it would be profitable, then criterion (b) will not be satisfied.

4.5 One reason given by the High Court for favouring the 'private profitability' test over a 'natural monopoly' test was that the latter test may fail to address situations where a facility has natural monopoly characteristics, but it is nonetheless not privately profitable to duplicate that facility. The High Court observed:[31]

> *"…if criterion (b) is read as a natural monopoly test, a facility that is not a natural monopoly cannot be declared even if there is no (profit) incentive to duplicate it. In that case, the sole supplier would be left in control of the field with the attendant risks of abuse of market power and, no less importantly, with no incentive to price and produce efficiently. An outcome of that kind does not sit easily with the requirement that criterion (b) be understood in a way that will "promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets".*"

4.6 A further issue identified by the High Court was that the 'natural monopoly' test was likely to be very difficult to apply, since it requires numerous assumptions regarding the future state of the relevant market(s) and the cost to serve that market under different supply configurations. The High Court observed:[32]

> *"Although the Tribunal concluded that criterion (b) should be read as requiring a natural monopoly test, it expressly acknowledged that "[t]esting for a natural monopoly is notoriously difficult ... because of the difficulty in obtaining relevant cost information". Yet the Tribunal said that the test should be applied because, in the words of an expert witness adopted by the Tribunal, the test "tries to answer the right question" (emphasis added). Why the Act should be construed as requiring the application of a test that is "notoriously difficult" to apply and why the question posed by the natural monopoly test was "the right question" was not elucidated by reference to any consideration beyond the frequency of reference in the Hilmer Report to "natural monopoly". And as the Tribunal rightly pointed out, the legislation and the Competition Principles Agreement that followed the Hilmer Report "adopted a more elaborate series of criteria for declaring access than those which were originally recommended". Further, as the Tribunal also recognised, a facility may be a natural monopoly at the time of declaration but it may not be one tomorrow. Why the Act should be construed as requiring the application of a test that now can be applied only with difficulty, and cannot be applied at all in respect of the long period for which a service may be declared, was not explained.*"

4.7 The potential difficulties associated with the application of the natural monopoly test have also been recognised by the Commission.[33]

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[30] *Pilbara*, [81].

[31] *Pilbara*, [103].

[32] *Pilbara*, [93].

[33] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013, p 156.

Recent amendment to criterion (b)

4.8 As for criterion (a), the amendment to criterion (b) flows from recommendations made by the Commission in its 2013 inquiry. This inquiry came shortly after the High Court's decision in *Pilbara.*

4.9 The Commission's view was that criterion (b) should be applied "in a different manner than in the past". The Commission strongly favoured an approach to criterion (b) that was based on the natural monopoly test.[34]

4.10 The explanatory memorandum accompanying the amendment confirms that it is intended to reframe criterion (b) as a 'natural monopoly' test. The explanatory memorandum states:[35]

> *"Paragraph 44CA(1)(b) asks whether the facility that provides (or will provide) the service could meet the total foreseeable market demand at least cost over the declaration period. This is in comparison to a scenario where there are two or more facilities. The amendment to this paragraph is intended to refocus the test to a 'natural monopoly' test instead of a 'private profitability' test."*

4.11 Consistent with this intent, the language of the new criterion (a) is very closely modelled on the High Court's description of the 'natural monopoly' test in *Pilbara*.[36]

Effect of the change to a natural monopoly test

4.12 Applying the new criterion (b) as a natural monopoly test will involve a number of steps:

(a) *Defining the relevant market for the service* – an applicant for declaration needs to define the market (or markets) in which the service is supplied.

(b) *Estimating foreseeable demand for the service (over term of declaration)* – the second step is for demand to be estimated (or forecast) for the defined market. The estimate or forecast of demand would need to cover the declaration period.

(c) *Assessing whether the facility could meet total foreseeable market demand for the infrastructure service over the declaration period at least cost* – this final step requires a comparison of total production costs in two scenarios – a scenario in which foreseeable demand (estimated in step (b) above) is met by one facility; and a scenario in which this demand is met by two or more facilities. The alternative facilities used for this analysis may be an existing substitute and/or a hypothetical duplicate facility.

4.13 At each stage, assumptions and judgements are made regarding substitutability of alternative facilities, market demand, and costs under different supply configurations. Each element of this process is likely to be contentious and require large amounts of economic and technical evidence.

4.14 Whether the natural monopoly test would deliver a different final outcome to the private profitability test will depend on individual circumstances. In some circumstances the outcome may be the same, for example if a facility has natural monopoly characteristics and it would not be profitable for anyone to duplicate it. However, as noted by the High Court in *Pilbara*, there

[34] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013, p 160.

[35] Explanatory Memorandum, Competition and Consumer Amendment (Competition Policy Review) Bill 2017, [12.22].

[36] *Pilbara*, [79].

may be cases where a service would not satisfy the natural monopoly test, but would have satisfied the private profitability test.[37]

4.15 What is clear though is that criterion (b) has become more difficult to satisfy in a practical sense. As noted by the Tribunal and the High Court in *Pilbara*, testing for a natural monopoly is "*notoriously difficult*".[38]

5 Changes to the public interest criterion

5.1 Criterion (d) (previously criterion (f)) has been amended as follows:

> *"…that access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote ~~not be contrary to~~ the public interest."*

5.2 As can be seen, there are two important aspects to this amendment:

(a) the public interest assessment is now in relation to the effect of declaration, not access; and

(b) the decision-maker now needs to be positively satisfied that the declaration would promote the public interest, not just that this would not be contrary to the public interest.

5.3 Like the amendments to criteria (a) and (b), these amendments were recommended by the Commission in its 2013 inquiry. The Commission report makes clear that the intent of these changes is to "strengthen" the public interest test and "raise the hurdle" for declaration.[39] The Commission expressed the view that the (then prevailing) construction of the public interest test had set a hurdle for declaring an infrastructure service that was too low.[40]

5.4 In our view, consistent with the explanatory materials, the change to criterion (d) has further raised the hurdle for declaration.

6 Conclusion

6.1 In our view, the recent changes to the declaration criteria have significantly increased the hurdle for declaration under Part IIIA of the CCA, particularly for users of non-vertically integrated infrastructure such as airports.

6.2 In relation to non-vertically integrated infrastructure, we consider the change to criterion (a) to be most significant. By reinstating a with / without declaration test, and dispensing with the with / without access test, the amendment is likely to significantly increase the hurdle for users of non-vertically integrated infrastructure seeking declaration. Previously an applicant was likely to satisfy criterion (a) if it could be demonstrated that access to the relevant service was required in order for users to be able to compete in dependent markets – a surmountable hurdle for users of critical infrastructure, such as a major airport. However it now needs to be demonstrated that a change in the terms of access as a result of declaration would materially improve conditions for upstream or downstream competition.

[37] *Pilbara*, [103].

[38] *Pilbara*, [93].

[39] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013, pp 176-181.

[40] Productivity Commission 2013, National Access Regime, Inquiry Report No. 66, 25 October 2013, p 178.

6.3 The design of criterion (a) is now such that it is unlikely to be satisfied in all cases where there is substantial market power, or even monopoly power. Rather, this criterion will only be satisfied where the exercise of monopoly power is leading to terms and conditions of access that are disrupting or inhibiting competition in another market.

6.4 As has been noted by the ACCC, in cases of non-vertically integrated infrastructure, abuse of monopoly power by the infrastructure owner / operator is still likely to damage economic efficiency, but not necessarily through diminution of competition. In such cases, the former criterion (a) was likely to have been satisfied (as it was in *Port of Newcastle* and *Sydney Airport*), and so such abuses could be remedied under Part IIIA of the CCA. However the amended criterion (a) will not be satisfied in these cases if competition in dependent markets is unaffected, and hence there will be an economic problem that is not addressed by the new Part IIIA criteria.

6.5 While we consider the change to criterion (a) to be the most significant, in terms of its likely effect on the outcome of any application for declaration in respect of non-vertically-integrated infrastructure, we note that the amendments to criteria (b) and (d) also present additional challenges for applicants and are likely to further increase the overall threshold for declaration. We consider that the change to a 'natural monopoly' test under criterion (b) means that this criterion will now be more difficult to satisfy, at least in a practical sense. The changes to the public interest criterion are expressly intended to raise the hurdle for declaration, and in our view are likely to do so – whereas previously the NCC / Minister only needed to be satisfied that access would not be contrary to the public interest, now the NCC / Minister needs to be positively satisfied that declaration (not just access) would promote the public interest.

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