Productivity Commission Inquiry: Economic regulation of airport services

Submission by Virgin Blue Airlines

Non-confidential version

18 April 2011

Contents

1 Introduction and Executive Summary

Virgin Blue Airlines Pty Limited (**Virgin Blue**) welcomes the opportunity to make this submission to the Productivity Commission (**Commission**) in response to the Commission's inquiry into the economic regulation of airport services.

Virgin Blue considers that implementing appropriate economic regulation of airport services is crucial to ensure the efficient operation of the Australian aviation industry and the delivery of socially optimal outcomes for the travelling public, tourism and related industries, and society as a whole. Appropriate economic regulation should provide incentives for airports to efficiently price services while addressing the imbalance in negotiating power between airports and airlines. Virgin Blue's strong preference is to commercially negotiate agreements with airports. However, since airports have monopoly power and the incentive to use it to increase prices and reduce the quality of the services they provide, effective safeguards are required to constrain this power.

1.1 Airports have substantial market power

As the Australian Competition and Consumer Commission (**ACCC**) has most recently recognised in its *2009-10 Airport Monitoring Report*:

> 'The price-monitored airports have significant market power and the ACCC considers that the airports have the incentives and ability to exercise their market power.'[1]

While Virgin Blue acknowledges that the degree of market power varies between Tiers of airports, Virgin Blue considers that, in addition to the monitored airports, Tier 2 and some Tier 3 airports also have significant market power.[2]

Airlines do not have countervailing power: demand for aeronautical services at airports is highly inelastic. In most cases, airlines have no choice but to use services at a particular airport as there are no available substitutes and to withdraw from an airport would mean that airlines would need to cease offering services to and from that destination, with consequent damage to their network offering and overall business.

1.2 Airlines have limited ability to negotiate pricing outcomes with airports

Airlines have limited ability to negotiate pricing outcomes with airports. In Virgin Blue's experience, negotiations with airports are difficult due to their often protracted nature, the inflexible approach taken by some airports, and the frequent lack of transparency in negotiations.

1.3 There is strong evidence of monopoly pricing and service standards

As a result of this power imbalance, Virgin Blue considers that airports are able to, and do, engage in monopoly pricing by:

- manipulating the inputs into their calculation of rates of return in order to obtain unreasonable and inefficiently high prices (and hence returns);
- failing to take into consideration trade-offs in capital and operating expenditure and in some cases double recovering costs;

---

1 ACCC 2009-*10 Airport Monitoring Report*, January 2011, p x.

2 In this submission, we have classified airports as follows:

- Tier 1: Sydney Airport, Brisbane Airport, Melbourne Airport, Adelaide Airport, Perth Airport;
- Tier 2: Canberra Airport, Hobart Airport, Gold Coast Airport, Cairns Airport, Darwin Airport; and
- Tier 3: all other airports.

- unreasonably passing all costs onto airlines and shifting investment risk to airlines;
- passing on costs associated with inefficient investments and project mismanagement; and
- classifying services (and therefore costs) as aeronautical or non-aeronautical to maximise profits.[3]

Across a range of airports, charges for aeronautical services (and other services not currently classified as aeronautical) have been rapidly increasing over the last decade, to the point where they are now significantly above the long run costs of providing these services. These charges now comprise a very large proportion of airfares. At the same time, the quality of the services at a number of airports has continued to fall despite rising revenues.

Airports often seek to justify their high rates of return on the basis that it is appropriate for the high level of risk they face. However, recent experience with the Global Financial Crisis (**GFC**) further demonstrates that airports' claimed levels of risk are significantly inflated and that their rates of return have therefore been excessive in this respect alone. When demand for air travel drops, as it did during the GFC, airlines discount fares in order to stimulate demand and keep load factors steady. Airports do not alter their charges in response to demand shocks. As a result, as airfares drop, airport charges remain the same and become a higher proportion of airfares. In this way, the risk of sharp falls in demand is borne almost entirely by airlines. In particular, airports pass on to airlines all costs incurred, regardless of the efficiency or reasonableness of these costs, including overruns on projects. This means that airlines bear the risk of changes to the scope, timing or cost of investments and airports have no incentive to ensure that risks associated with projects are minimised. Further, in Virgin Blue's experience, some airports transfer investment risk to airlines by passing through the cost of infrastructure projects before they are available for use, resulting in airlines pre-funding investments.

Nor are airports complying with the Government's *Aeronautical Pricing Principles* (revised in April 2007). For example:

- returns are well above that commensurate with the regulatory and commercial risks involved;
- there are no incentives to reduce costs or otherwise improve productivity;
- on some occasions there is a lack open and transparent exchange of information in negotiations;
- service level outcomes are often well below reasonable expectations; and
- prices do not reflect a reasonable sharing of risks and returns.

In summary, current airport pricing cannot be justified on the basis of costs, new investment requirements or other enhancements to service quality alone. This suggests that the current system of economic regulation does not adequately protect against the exercise of market power by airports and results in inefficiencies and substantial consumer detriment.

1.4 The current regulatory regime is not effective

Virgin Blue considers that:

[3] As discussed in sections 8 and 10.4.

- airlines cannot effectively commercially negotiate with major Australian airports except in cases where the airports have a special commercial incentive to do so;

- airports have been able to increase airport aeronautical charges above efficient levels and increases in charges have significantly exceeded increases in costs; and

- at the same time, services at airports have not generally improved or, worse, have deteriorated.

This demonstrates that the current economic regulatory regime is not effective in deterring potential abuses of market power. To the contrary, airports have been able to engage in monopoly pricing and related abuses of their market power.

Further, as discussed below, the current price monitoring regime and the declaration provisions of Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**) have their limitations.

Interestingly, experience with Part IIIA of the CCA clearly demonstrates that:

- it is ineffective at constraining airports' market power due to the time, cost and uncertainty inherent in the declaration process;

- however, once an airport service has been declared, the resulting negotiate-arbitrate regime that comes into operation is very effective at resolving disputes and does not (as some had feared) result in any automatic resort to arbitration by airlines or airports.

1.5 Proposed model for economic regulation of airports

Despite the deficiencies in the current regulatory model, Virgin Blue considers that there is no basis for re-regulating airport pricing as this would increase compliance costs for both airlines and airports and may lead to inefficient outcomes.

Any regulatory model should emphasise the primacy of commercial negotiations to determine the terms and conditions on which airport services are provided. However, the current regulatory environment does not adequately facilitate commercial negotiations between airlines and airports due to the bargaining power imbalance that arises from airports' substantial market power and the inelastic demand for services at most airports.

Virgin Blue considers that a negotiate-arbitrate model would address this problem and the mere threat of independent arbitration in the absence of commercial agreement would encourage truly commercial negotiations between airlines and airports. This is the same position that Virgin Blue put to the Commission in 2006.

Virgin Blue proposes a light handed negotiate-arbitrate model (**Proposed Model**) with the following features:

- the model would apply to **aeronautical related services** provided at **major airports** in Australia, where:

    - aeronautical related services extends beyond the current regulatory definition of aeronautical services to include all services provided within a terminal and all other services used by passengers travelling on airlines; and

    - major airports are the following Tier 1 and Tier 2 airports: Sydney Airport, Melbourne Airport, Brisbane Airport, Perth Airport, Adelaide Airport,

Canberra Airport, Darwin Airport, Gold Coast Airport, Hobart Airport and Cairns Airport;

- first and foremost, airlines and airports would be encouraged to commercially negotiate for the provision of airport services;
- in the event that the parties could not agree on the terms and conditions for the supply of aeronautical related services, users and providers would have the ability to refer the dispute to independent arbitration;
- in order to assist commercial negotiations and reduce the need for any arbitrations:
  - pricing and costing guidelines would be issued addressing key issues in negotiations over the provision of aeronautical related services; and
  - the price monitoring regime would continue (with improvements) to ensure that airlines and airports have up to date, accurate and transparent information about airports' costs and prices.

Under the Proposed Model, the independent arbitrator could be the ACCC (in which case the Proposed Model could be implemented in part through the deemed declaration of aeronautical related services at major airports) or another independent person or body with the relevant experience.

In the past, concerns have been expressed that the introduction of any negotiate-arbitrate model would undermine commercial negotiations because parties would resort automatically to arbitration. Virgin Blue has never shared these concerns, and believes that the recent experience with the declared Airside Service at Sydney Airport demonstrates that such concerns are misplaced. For the declared Airside Service, in the 5 year period it was declared, only the initial dispute that led to the declaration process was notified to the ACCC. Even this dispute was quickly resolved through commercial agreement and never proceeded to a hearing.

Clearly, declaration did not lead to a situation where parties preferred arbitration to commercial negotiation. Virgin Blue cannot see any reason why the same position would not apply for other aeronautical related services at other major airports.

2 Background to the economic regulation of airport services

2.1 The privatisation of Airports

Prior to 1997, the main airports in Australia were owned and operated by the Federal Airports Corporation established under the *Federal Airports Corporation Act 1986* (Cth).

In 1997 and 1998 the Commonwealth Government effectively privatised most of Australia's large airports by leasing them to private operators for a term of 50 years, with an option to renew for a further 49 years. These airports included the major monitored airports as well as Tier 2 airports.

Sydney Airport was an exception. While it was subject to a lease of the same duration as the other airports, it was leased to Sydney Airport, which was at that time wholly-owned by the Commonwealth Government. In 2002 all the shares in Sydney Airport were acquired by Southern Cross Airports Corporation, such that Sydney Airport is now privately operated.

2.2 Initial regulation

At the time of privatisation, price regulation under the *Prices Surveillance Act 1983* (Cth) was introduced for airports designated as 'core regulated airports' under the *Airports Act 1996* (Cth). This price regulation comprised price notification for aeronautical services and Consumer Price Index (CPI) minus X price caps and special provisions for new investment. Some quality of service monitoring was also introduced.

2.3 2002 Productivity Commission inquiry

In 2002, the Commission undertook an inquiry into the price regulation of airport services. The principal recommendations of the Commission following that inquiry were that price notification for certain airports (and the price caps) should be replaced by 'mandatory price monitoring arrangements for a probationary five year period' with an independent public review at the end of that period.

From this point until 2007, regulation was largely concerned with price and quality monitoring of aeronautical services at seven major airports (Sydney, Melbourne, Brisbane, Perth, Adelaide, Canberra and Darwin). Only price notification arrangements for regional air services using Sydney Airport remained.

2.4 2006 Productivity Commission review

a) Commission's findings and recommendations

In 2006, the Commission undertook another review into the price regulation of airport services.

The principal recommendations of the Commission were that price monitoring should continue with some modifications (recommendation 5.5), and should apply to:

- all services for which airports have significant market power (recommendation 5.2); and
- Adelaide, Brisbane, Melbourne, Perth and Sydney Airports only (recommendation 5.1).

The Commission also recommended that the Government should consider amendment to the national access regime under Part IIIA to ensure that the regime left open the option of using price monitoring and other light handed approaches for regulating access (recommendation 3.1).

A 'show cause mechanism' was also recommended. Under this mechanism, airports would be asked to 'show cause' why their conduct should not be subject to more detailed scrutiny through a Part VIIA price inquiry or other appropriate investigative mechanism (recommendation 4.1).

The Commission also recommended that a 'line in the sand' approach for valuations of an airport's asset base for monitoring purposes should be introduced, and that the ACCC should consult with airports and airlines on how best to accommodate differences in statutory and regulatory reporting requirements within the new price monitoring regime (recommendations 4.2 and 4.3).

In relation to the existing Review Principles, the Commission also stated that these should govern assessments of airport behaviour during the next period of price monitoring and recommended that three additional new Review Principles should be introduced, specifically that:

- further asset revaluations should not generally provide a basis for higher charges for monitored aeronautical services;

- parties should negotiate in 'good faith' to achieve outcomes consistent with the principles, including through the negotiation of processes for resolving disputes in a commercial manner; and

- there should be reasonable sharing of risks and returns between airports and their customers (recommendation 4.4).

In relation to calls for airport specific arbitration, the Commission recommended that neither an airport specific arbitration regime, nor mandatory information disclosure requirements should be introduced (recommendation 4.5).

b) The Government response

On 30 April 2007, the Treasurer issued a press release[4] and the Government's response to the 2006 review.

One of the key recommendations of the Commission in 2006, which was accepted by the Government in its response, was that a 'show cause' mechanism should be introduced. Under such a mechanism each year the relevant Minister would be required to review the ACCC's monitoring reports and other relevant information and state either that:

- no further scrutiny of the monitored airports is necessary; or

- that one or more of the airports should 'show cause' why their conduct should not be subject to more detailed scrutiny through a Part VIIIA price inquiry or other appropriate investigative mechanism.

However, despite the Department of Infrastructure, Transport, Regional Development and Local Government issuing draft 'show cause' guidelines in 2009, even this potential constraint on airport conduct (imperfect as it was) was abandoned in light of concerns exposed by stakeholders'.[5]

2.5 The current review

In 2010, the Government asked the Commission to investigate airport pricing, investment and services. The Commission was asked to assess the effectiveness of current economic regulation of airports in supporting ongoing investment in aviation infrastructure while deterring potential abuses of market power.

As the Minister for Infrastructure and Transport noted when announcing the review:

> 'We have brought this Inquiry forward to shine a spotlight onto a range of charges at the nation's major airports including Sydney, Melbourne, Brisbane and Perth.'[6]

The inquiry had been brought forward from 2012 as a response to the ACCC's findings in its *Airport Monitoring Report 2009-10*.

---

4 Press Release No 032, Treasurer, Productivity Commission Report – Review of price regulation of airport services, 30 April 2007.

5 *Aviation White Paper*, December 2009, p 180.

6 Media Release AA492/2010, The Hon Anthony Albanese MP, 'Airport Pricing, Investment and Services Review', 9 December 2010.

3 Virgin Blue's business model and the importance of airport pricing

3.1 Virgin Blue's business model: providing high quality service with a low cost base

Virgin Blue commenced operations in August 2000 as a low cost carrier (**LCC**) serving a small number of domestic Australian routes. Since that time, Virgin Blue has expanded its operations to include a network of over sixty domestic and international destinations which are served by aircraft operated by Virgin Blue, V Australia, Pacific Blue and Polynesian Blue and through codeshare and alliance arrangements with other airlines. The ability of Virgin Blue to continue to provide and expand its network and provide high quality services is dependent on its ability to maintain a low cost base.

Since its entry in 2000, Virgin Blue has made, and continues to make, a number of changes to its business model in order to take account of changing conditions in the Australian aviation industry and to pursue opportunities to increase profitability.

In late November 2005, Virgin Blue re-defined its business model and announced its move towards becoming a New World Carrier (**NWC**). A NWC is a low cost, high value airline model that aims to attract a broader cross section of passengers than the traditional LCC model, through leveraging the airline's low cost foundations and adding valuable new products which appeal to higher yielding passengers. This NWC strategy allowed Virgin Blue to continue low cost operations while strengthening yields and profitability. As part of this strategy, Virgin Blue introduced additional services including, Velocity, The Lounge, self check-in kiosks, premium economy, Corporate plus fares and Blueholidays and expanded its network reach by purchasing new aircraft and adding new destinations to its network.

Virgin Blue is now embarking on a 'Game Change' strategy to improve its network and product in order to expand its passenger base and challenge Qantas across more market segments, providing enhanced choice and competition for all Australian passengers.

Virgin Blue's strategy is to retain its competitive position for leisure and visiting friends and relatives (**VFR**) travel in domestic Australia while reducing its exposure to fluctuations in demand for leisure travel by diversifying its passenger base and attracting a higher proportion of Australian corporate, government and international travellers.

Virgin Blue aims to bring its low cost position and challenger brand to all sectors of the Australian air travel market. The leisure market is, and will continue to be, a core segment where Virgin Blue will continue to focus and bring true competition.[7] Qantas currently dominates the Australian corporate and government sectors and has the largest share of international travel to and from Australia.[8] Virgin Blue aims to bring competition to these sectors just as it did to the leisure sector ten years ago.

In order to achieve this strategy Virgin Blue is tailoring its product with the aim of being both cost efficient and delivering a great service that is valued by all passengers.[9] Recently announced elements of this strategy include the introduction of business class services, upgraded in-flight entertainment and food, new look cabins, uniforms and livery

---

7 For more details on Virgin Blue's strategy, see: Presentation by John Borghetti, Virgin Blue Chief Executive Officer, Annual Stockbrokers Conference, Melbourne, 8 June 2010.

8 For the year ended January 2010, the Qantas Group had a 28.6% share of international passengers into and out of Australia, followed by Singapore Airlines with a 9.8% share. Pacific Blue had the fifth largest share of traffic at 6%. See also Figure 3 below.

9 See generally: Presentation By John Borghetti, Virgin Blue Chief Executive Officer, Annual Stockbrokers Conference, Melbourne, 8 June 2010.

and a broader and deeper network through strategic international alliances, codeshare agreements and V Australia's services.

In order to compete for all Australian passengers including for corporate accounts, Virgin Blue must be able to offer innovative services attractive to higher yield passengers, including corporate accounts, while maintaining an efficient cost base enabling them to continue to offer fares attractive to all passengers and, in particular, leisure travellers. Airport charges are a significant proportion of Virgin Blue's cost base and the fares paid by passengers. Monopoly pricing by airports inefficiently increases Virgin Blue's cost base and could undermine its ability to offer high quality services with competitive fares.

3.2 Airport aeronautical charges are a significant proportion of costs

The aeronautical charges levied by airports on airlines are a significant proportion of airlines' costs, particularly for domestic operations.

Further, these charges have been increasing steadily as a proportion of airlines' fares since the Commission's last review in 2006.

[**CONFIDENTIAL**]

As can be seen from the above graph, combined terminal and landing fees comprised almost [**CONFIDENTIAL**] of Virgin Blue's average fare in 2010, up from [**CONFIDENTIAL**] of the average fare in 2006 when the Commission last reviewed the economic regulation of airport services. Virgin Blue pays additional aeronautical charges, which are not included in terminal and landing fees, for security, leasing of operational space, ground-handling, navigation (Airservices Australia charges) and aviation rescue and fire fighting charges. These additional aeronautical charges comprise a further [**CONFIDENTIAL**] of Virgin Blue's average fare.

This is a very high proportion of the average fare, particularly given that all of the following costs also have to be recovered from the fare before an airline can make any profit:

- staff expenses;
- aircraft leasing and financing costs;
- engineering costs;
- fuel;
- sales and marketing; and
- overheads.

The figures set out above are, of course, average figures. For many routes, airports' aeronautical charges can amount to an even higher proportion of the average fares for those routes. For example, in 2010, terminal and landing charges amounted to almost [**CONFIDENTIAL**] of the average fare on the Melbourne-Canberra route and [**CONFIDENTIAL**] of the average fare on the Melbourne-Adelaide route.

A review of the Sydney-Melbourne route, the busiest route in Australia, shows the impact of airport aeronautical charges, by reference again to terminal and landing charges.

[**CONFIDENTIAL**]

This sharp increase in aeronautical charges as a proportion of the average fare is a result of two factors working together in the period since 2006:

- first, airport terminal and landing charges have increased steadily over the period (as they have done consistently since airports were privatised); and

- secondly, driven by weaker economic conditions and the highly competitive environment in the airline industry, average fares have been decreasing.

It is worthwhile noting that while competition and weaker economic conditions have had a significant impact on airlines' pricing and profitability, in this same period airports have enjoyed increased aeronautical pricing, increased passenger numbers and increased aeronautical revenue. This point was noted in the ACCC's most recent monitoring report.[10]

This impact can be seen below, again using the Sydney-Melbourne route as an example and tracking the fall in the average fare against landing fees and terminal fees:

[**CONFIDENTIAL**]

Generally, since 2006 aeronautical charges have increased as a proportion of average fares across most of Virgin Blue's domestic routes. This is demonstrated below in Figures 4 and 5 using airports' terminal and landing charges.

[**CONFIDENTIAL**]

For the reasons discussed in detail in section 6, aeronautical charges at airports in Australia are excessive and have been set well above efficient levels.

Recent falls in average fares for domestic air travel in Australia should not be allowed to mask the economic and social consequences of these excessive charges.

Excessive charges levied on airlines by airports have two important consequences for airlines, the travelling public, those industries that are dependent on travel and the broader economy:

- to the extent that excessive aeronautical charges are passed on to the travelling public in the form of higher fares, these charges reduce air travel consumption below efficient levels, resulting in deadweight losses, and flow on effects to industries such as the tourism industry; and

- to the extent that they are borne by airlines in the form of reduced profits, they result in reduced investment in the airline industry, which translates into the sub-optimal supply of airline services, including fewer flights and an under-investment in new routes.

Individual airlines will choose the extent to which they absorb the excessive charges and the extent to which they seek to pass these charges on – the exact mix will depend upon a range of factors including the state of competition in the airline industry and the elasticity of demand that the airline faces for its services.

The sum of these effects means that, because of inefficient and excessive charging by airports for aeronautical services:

- air fares are higher; and

- the supply of airline services is lower;

[10] ACCC *Airport Monitoring Report 2009-10*, section 2.72.

than would otherwise be the case.

4 Market power of airports

4.1 Overview

In its 2002 report, *Price Regulation of Airport Services*, the Commission found that airports have natural monopoly characteristics. In the case of airports, natural monopoly characteristics were found to arise from:

- investment requirements, economies of scale and economies of scope; and
- network benefits, which determine the extent to which airlines are willing to spread their services across more than one airport in any given location.

These natural monopoly characteristics, combined with regulatory constraints, created significant barriers to entry in the provision of airports. The Commission stated that, considered in isolation, this would appear to give airports in Australia significant market power.

In particular, Brisbane, Melbourne, Perth and Sydney Airports were found to possess a high degree of market power in domestic markets due to high proportions of business and VFR travellers, and their status as the main international ports for arrival into, and departure from, Australia.

That particular major or monitored airports in Australia have significant market power has now also been recognised by bodies including the ACCC and the Australian Competition Tribunal (**Tribunal**).[11] Specifically, in the ACCC's *Airport Monitoring Report 2009-10*, the ACCC stated that:

> 'The price-monitored airports have significant market power—that is, an ability to raise prices above the efficient costs of supplying aeronautical services. In addition, the ACCC considers that a number of characteristics provide the airports with the incentives and ability to exercise their market power at the expense of users and earn monopoly rents from aeronautical services.' [12]

Virgin Blue agrees with the ACCC's above conclusion, and acknowledges that the degree of market power may vary between different Tiers of airports. Further Virgin Blue also considers that, in addition to the price-monitored airports, Tier 2 and some Tier 3 airports also have significant market power.

In this section, Virgin Blue responds to the following questions identified in the Commission's *Issues Paper* in relation to this market power:

- What are the constraints on the airports' market power? Do the airlines have countervailing power in dealing with the airports, especially smaller airports?
- Have there been changes in the overall market power enjoyed by any of the price monitored airports and if so why? For example, do Avalon and Gold Coast Airports materially reduce the market power of Melbourne and Brisbane Airports?

---

[11] *Re Virgin Blue Airlines Pty Limited* [2005] ACompT 5 at [164] (in relation to Sydney Airport only). The Australian Competition Tribunal stated that 'The existence of Sydney Airport's monopoly power was not controversial and, indeed, was accepted by all the economic experts called by the parties.'

[12] ACCC, *2009-10 Airport Monitoring Report*, January 2011, p 44.

4.2 Countervailing power as a constraint on the airports' market power

Virgin Blue considers there are no effective market constraints on airports' behaviour in exercising market power.

As set out in its submission to the Commission's 2006 review, Virgin Blue does not consider that complementary non-aeronautical revenue will constrain airports from charging amounts far in excess of the competitive price for aeronautical services. The Tribunal has also agreed with this proposition.[13] Virgin Blue notes that the Commission no longer contends (as it did in its 2002 report) that the constraints from these complementary charges is significant (see, for example page xvii of the Commission's 2006 report, *Review of Price Regulation of Airport Services*).

Further, as explained in section 7 below, price monitoring and the threat of re-regulation have not been effective in preventing misuse of market power.

In relation to the countervailing power of airlines as a constraint, in the *2009-10 Airport Monitoring Report*, the ACCC stated that: 'airlines generally have a low level of countervailing power in negotiating terms and conditions of access to the major airports.'[14] This is consistent with the Commission's finding in its 2006 report that: 'airlines generally have only modest countervailing power in dealing with the major airports.'[15]

These assessments are consistent with Virgin Blue's experience. Virgin Blue has found that it has little ability to influence the behaviour of major airports to constrain an attempted exercise of market power. Virgin Blue has also found that it has relatively modest countervailing power in relation to smaller Tier 3 airports. This is despite the economic value of Virgin Blue's business to airports as one of Australia's largest domestic carriers.

Often, this is because there is a single commercial airport servicing a population centre or geographic area, offering no alternative port with which airlines can negotiate. As a result, in most cases, Virgin Blue cannot plausibly threaten to bypass or to withdraw services to and from a particular airport, if that airport does not participate in commercial negotiations. In such circumstances, airlines have no choice but to use services at a particular airport as there are no available substitutes and to withdraw from an airport would mean that airlines would need to cease offering services to and from that destination, with consequent damage to their network offering. Virgin Blue has found this to be the case even in relation to those airports more heavily reliant on holiday traffic (and therefore in competition with other tourist destinations).

Further, in Virgin Blue's experience, the ability to do things like relocate maintenance or administration functions, engage in media campaigns or lobby for greater regulation do not provide strong constraints.

In relation to smaller Tier 3 airports, the fact that Virgin Blue has little countervailing power against these airports can be illustrated by the examples provided in section 5 below of the inflexible attitude taken in negotiations with smaller airports [**CONFIDENTIAL**].

---

13 In *Re Virgin Blue Airlines Pty Limited* [2005] ACompT 5, in relation to Sydney Airport, the Tribunal agreed that the constraining effect of complementary non-aeronautical revenue was weak at [511] and [512].

14 ACCC, *2009-10 Airport Monitoring Report*, January 2011, p 44.

15 Productivity Commission, *Review of Price Regulation of Airports Services*, report no 40, 14 December 2006, p XVII.

4.3 Changes in overall market power due to constraints from other airports

Virgin Blue does not consider that there have been changes in the overall market power enjoyed by the price monitored, major airports as a result of the growth of airports such as Gold Coast Airport and Avalon Airport.

Most airlines have little ability to bypass or withdraw their services from major airports. This is because the need to provide connectivity capability is a significant constraint on the ability of airlines to move services to other airports.

Further, network airlines in particular have special service features and infrastructure requirements. These can require a substantial, complex and costly investment in airport infrastructure which some airports are unable to provide. These include:

- large integrated networks, consisting of own networks and those of codeshare partners;
- connectivity capability to effect the seamless transfer of passengers and baggage both domestically and internationally;
- a more diverse fleet, which may require additional space to house parts and equipment for each;
- special services such as premium class travel, in flight catering and entertainment, lounges and valet parking services which require special infrastructure;
- aerobridge boarding and quality terminal facilities; and
- a range of other strategies designed to target higher passengers as well as the market overall.

Network airline customers are also more likely to be business travellers who are likely to want to continue to fly to larger airports such as Melbourne Airport and Brisbane Airport given that these are often closer to city CBDs.

5 Negotiations with airports under the current regulatory regime

5.1 Overview

As explained in section 4 above, airports have substantial market power. This is due to their position as natural monopolies, with substantial barriers to entry, large sunk costs and strong economies of scale. This is particularly the case with Tier 1 and Tier 2 airports, although Virgin Blue also considers that some Tier 3 airports have significant market power.

Airlines do not have countervailing power against the market power of airports. Demand for aeronautical services at airports is highly inelastic. In most cases, airlines have no choice but to use services at a particular airport as there are no available substitutes and to withdraw from an airport would mean that airlines would need to cease offering services to and from that destination, with consequent damage to their network offering.

As a result, there is an imbalance in bargaining power between airlines and airports in commercial negotiations. As explained in section 7 below, the current regime is not effective in addressing this issue.

Outside of situations where there is a commercial incentive for airports to reach agreement, Virgin Blue has often found negotiations with airports to be very difficult.

This was noted in Virgin Blue's submission to the Commission in relation to its 2006 review. Virgin Blue continues to find negotiations with airports to be very difficult.

In particular, in addition to concerns regarding the pricing conduct of airports raised in section 6 below, Virgin Blue has the following concerns:

- negotiations with airports in relation to both price and non price matters can be extremely protracted. Negotiations between Virgin Blue and airports often extend over many months, and, in some cases, extend over more than 12 months;

- there can be a lack of transparency in negotiations with airports. For example, some airports can be unwilling to share with Virgin Blue information regarding the basis for price increases which are often the subject of negotiations, which makes the negotiation of such changes extremely difficult; and

- airports will on occasion adopt an inflexible approach to negotiations. This includes the refusal of airports to agree to certain provisions that are common in other competitive industries, such as effective dispute resolution clauses. It also includes the imposition by airports of unreasonable or uncommercial terms. In circumstances where not reaching agreement would involve Virgin Blue ceasing to operate services to or from the airport, with resulting damage to its network and service offer and detriment to consumers, this leaves little room for negotiation.

On the other hand, Virgin Blue has found that where there have been incentives for airports to negotiate commercially, the commercial negotiation process has been fruitful. [**CONFIDENTIAL**]

In this section, Virgin Blue provides airport-specific examples that illustrate the difficulties that Virgin Blue has experienced in negotiating with airports. Details of the conduct of airports in relation to pricing in the negotiations mentioned below are provided in section 6.

5.2 Examples of Virgin Blue's current experience in negotiating with airports

[**CONFIDENTIAL**]

5.3 Commercially negotiated outcomes will only be possible if airports have the incentive to negotiate and airlines have recourse to arbitration

Virgin Blue considers that it is possible for airlines and airports to effectively negotiate commercially in relation to a range of matters where there is a sufficient incentive for both parties to negotiate. However, given the market power that major airports have in relation to the provision of airport aeronautical charges, negotiations are unlikely to be commercial unless:

- unusual circumstances create an incentive to negotiate commercially [**CONFIDENTIAL**]; or

- there is an externally imposed 'circuit breaker,' such as recourse to arbitration.

Despite this, Virgin Blue considers that commercially negotiated outcomes between airports and airlines are the preferred option. Virgin Blue's proposal for a negotiate-arbitrate regulatory solution are discussed further in section 10 below.

6 Analysis of pricing and services at major Australian airports

6.1 Aeronautical Pricing Principles

In response to the Commission's recommendations in its 2006 report, *Review of Price Regulation of Airport Services,* the Government issued revised *Aeronautical Pricing Principles*. It stated that these should act as a guide for the conduct of all airports, whether price monitored or not, and that compliance with these principles would be used by the Government in assessing the pricing conduct of monitored airports.

These *Aeronautical Pricing Principles* are:

a) that prices should:

   (i) be set so as to generate expected revenue for a service or services that is at least sufficient to meet the efficient costs of providing the service or services; and

   (ii) include a return on investment in tangible (non-current) aeronautical assets, commensurate with the regulatory and commercial risks involved and in accordance with these Pricing Principles;

b) that pricing regimes should provide incentives to reduce costs or otherwise improve productivity;

c) that prices (including service level specifications and any associated terms and conditions of access to aeronautical services) should:

   (iii) be established through commercial negotiations undertaken in good faith, with open and transparent information exchange between the airports and their customers and utilising processes for resolving disputes in a commercial manner (for example, independent commercial mediation/binding arbitration); and

   (iv) reflect a reasonable sharing of risks and returns, as agreed between airports and their customers (including risks and returns relating to changes in passenger traffic or productivity improvements resulting in over or under recovery of agreed allowable aeronautical revenue);

d) that price structures should:

   (v) allow multi-part pricing and price discrimination when it aids efficiency (including the efficient development of aeronautical services); and

   (vi) notwithstanding the cross-ownership restrictions in the *Airports Act 1996*, not allow a vertically integrated service provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher;

e) that service-level outcomes for aeronautical services provided by the airport operators should be consistent with users' reasonable expectations;

f) that aeronautical asset revaluations by airports should not generally provide a basis for higher aeronautical prices, unless customers agree; and

g) that at airports with significant capacity constraints, peak period pricing is allowed where necessary to efficiently manage demand and promote efficient investment in and use of airport infrastructure, consistent with all of the above Principles.

6.2 Overview of pricing since 2007

The ACCC's *Airport Monitoring Report 2009-10* provides evidence to suggest that the monitored airports have increased charges by more than can be justified on the basis of costs, new investment requirements or other enhancements to service quality. In particular, the ACCC's report concludes that the monitoring results raise questions about whether or not Sydney Airport has undertaken sufficient investment in services provided to airlines and, when considered in the context of the airport's market power, point to Sydney Airport earning monopoly rents from services provided to airlines. The ACCC also concludes that the price monitored airports have significant market power and the incentives and ability to exercise their market power.

These conclusions are consistent with Virgin Blue's experience of pricing and service not only at Sydney Airport but at a number of monitored and Tier 2 Australian airports, as well as certain Tier 3 airports. In Virgin Blue's experience, airports have consistently failed to comply with the *Aeronautical Pricing Principles*.

Virgin Blue considers that airports are able to, and do, engage in monopoly pricing by:

- manipulating the inputs into their calculation of rates of return in order to obtain unreasonable and inefficiently high prices (and hence returns);
- failing to take into consideration trade-offs in capital and operating expenditure and in some cases double recovering costs;
- unreasonably passing all costs onto airlines and shifting investment risk to airlines;
- passing on costs associated with inefficient investments and project mismanagement; and
- classifying services as aeronautical or non-aeronautical to maximise profits.[16]

As a result, since 2006 airport aeronautical charges have significantly increased in absolute terms. At the same time, as average air fares have reduced over the same period, charges are a large and growing proportion of the average fares paid by passengers and a very material proportion of Virgin Blue's operating costs (see section 3.2 above). This is the case at most airports, not only at the price monitored airports.

In this section of the submission, we provide airport-specific examples that illustrate these concerns and evidence monopoly pricing. This section also responds to the following questions identified in the Commission's *Issues Paper*:

- Is there evidence that the price monitored airports have increased charges by more than could be justified on the basis of costs, new investment requirements, and/or other enhancements to service quality?
- What is the ability of airports to vary prices year on year given many have long term contracts with airlines?
- How responsive have the monitored airports been to users' service needs and preferences? Are there any significant quality problems for services under the control of the airports that are not being addressed? Have necessary new investments been made in a timely fashion? How does the quality of service at the monitored airports compare with comparable international airports?

[16] As discussed in section 8 and 10.4.

6.3 Airport aeronautical charges and agreements

The Commission has inquired about the ability of airports to vary prices year on year given that many have long term contracts with airlines.

As discussed above, Virgin Blue has long term agreements with most airports which provide a base price for aeronautical charges derived from the airport's calculation of its allowable rate of return, using a building block formula. [**CONFIDENTIAL**] While the annual revenue amount and the base price for charges which are derived from that amount are set in the contract these are subject to increases over the life of the contract. There will typically be three mechanisms by which these figures increase annually:

- through increases in the asset base as a result of capital projects being completed which in turn increasing the value of the asset base;
- through annual increases in the operating expenditure of the airport, including in relation to repair and maintenance, staffing costs, utility costs and taxation; and
- through annual increases to the value of the asset base in line with CPI or another measure selected by the airport as occurs at all Tier 1 airports and some Tier 2 airports.

Separate from this contractual price path some airports pass on to airlines other unplanned costs through increases in aeronautical charges. [**CONFIDENTIAL**]

6.4 Evidence of increasing monopoly rents by the major airports

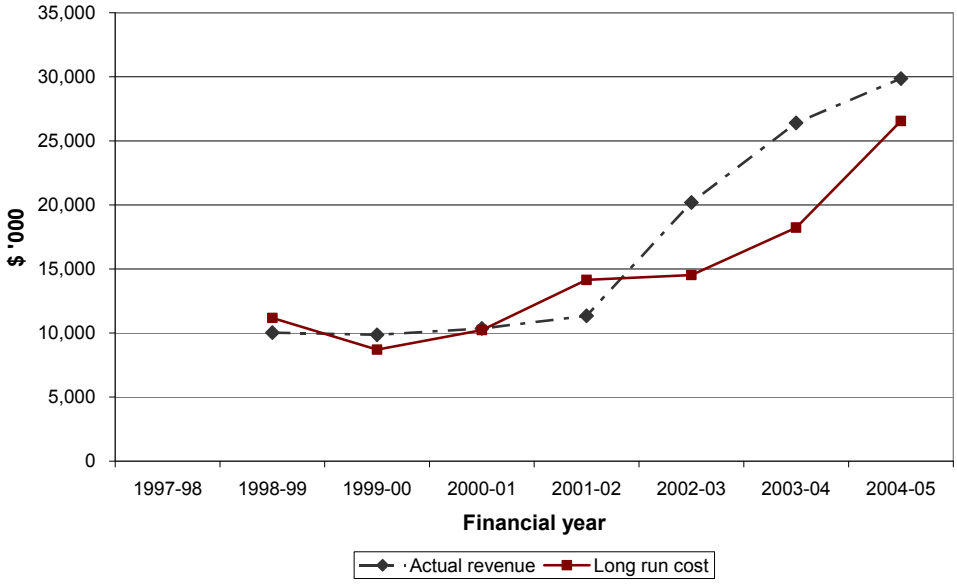
In addition to the examples discussed above, Virgin Blue considers that there is substantial evidence that increases in airport pricing do not reflect increases in costs. Rather, they are evidence of the ability of many airports to generate monopoly rents.

a) Material provided to the Productivity Commission's 2006 review

During the Commission's 2006 review of airport regulation, Virgin Blue provided extensive analysis demonstrating monopoly rent taking by the major airports. More specifically, the analysis demonstrated that the prices charged (and hence revenues earned) by the set of airports that were then subject to the monitoring regime had increased since the removal of formal price control by an amount that far exceeded the amount that would be justified by the increase in costs borne by the airport. Figures 6 to 7 reproduce those provided by Virgin Blue during the 2006 review that show how aeronautical revenue and long run cost compared over the period since the removal of price controls. Importantly, the calculation of long run cost:

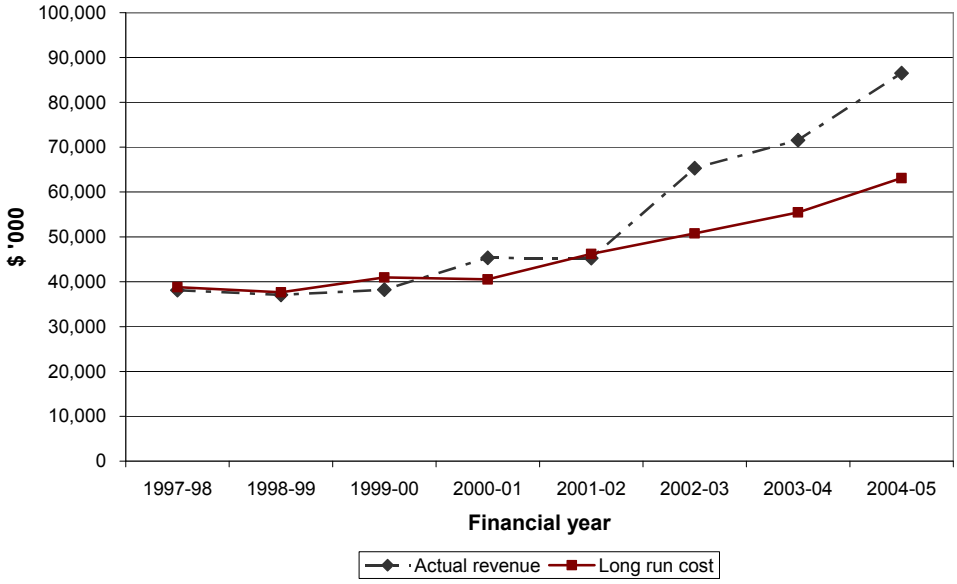
- assumes that the same level of 'return on' and 'return of capital' in relation to past investments that was received under the price control regime would continue into the future – thus, there was no assumption that assets should be written down reflecting their sunk nature, nor any assumption that sunk assets should be 'written up';
- all new investment would receive a commercial return and be depreciated; and
- any change in operating expenditure would translate directly into a change to long run cost.

Figure 6 - Adelaide Airport: aeronautical revenue vs long run cost



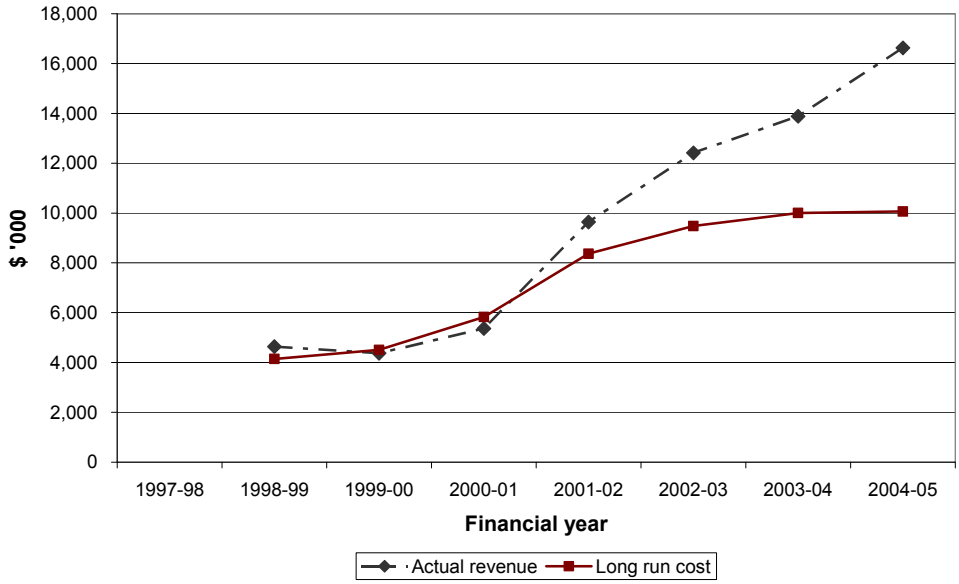
Source: ACCC Airport Regulatory Reports, 1997-98 to 2004-05

Figure 7 - Brisbane Airport: aeronautical revenue vs long run cost



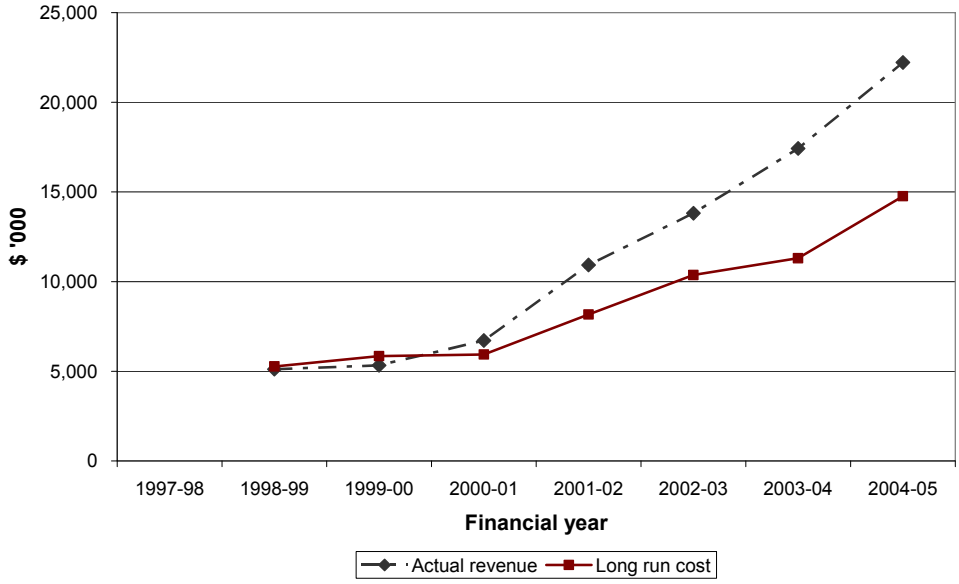
Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05

Figure 8 - Canberra airport: aeronautical revenue vs long run cost



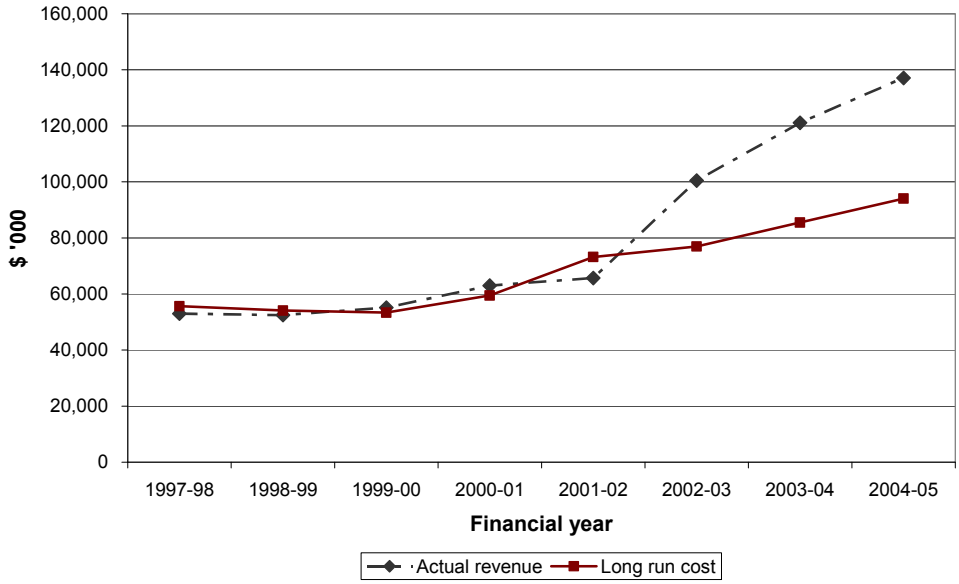
Note: Excludes $67m disposal of aeronautical assets reported in 2003-03.
Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05

Figure 9 - Darwin Airport: aeronautical revenue vs long run cost



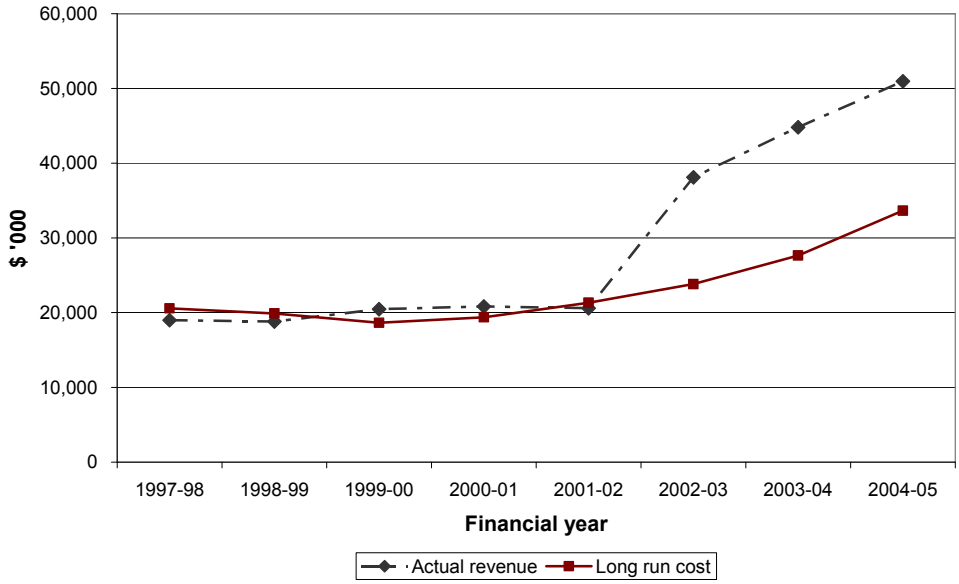
Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05

Figure 10 - Melbourne Airport: aeronautical revenue vs long run cost



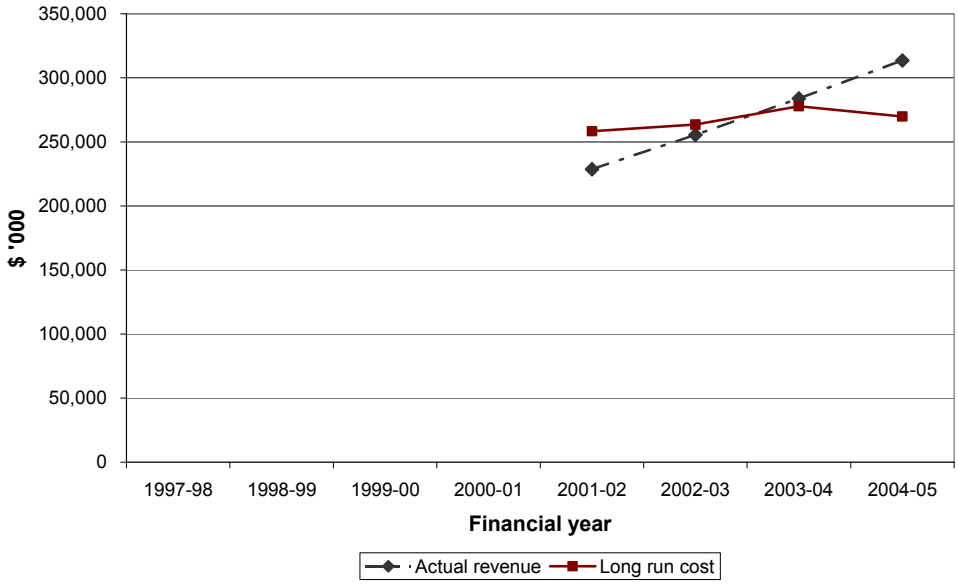
Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05

Figure 11 - Perth Airport: aeronautical revenue vs long run cost



Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05

Figure 12 - Sydney Airport: aeronautical revenue vs long run cost



Source: ACCC Airport Regulatory Reports 1997-98 to 2004-05; ACCC 2001, *Sydney Airports Corporation Ltd.: Aeronautical Pricing Proposal: Decision*, May.

These figures demonstrate that, with the exception of Adelaide Airport, all of the monitored airports had raised their prices by substantially more than could be justified by their change in costs. Moreover, the figures for Adelaide Airport were distorted at that time given that the long run cost in the figure included much of the new terminal cost, but the figure (and hence reported revenue) pre-dated the increase in prices associated with the terminal.

b) Airport pricing and costs since the 2006 review

Virgin Blue also considers that an analysis of the ACCC monitoring reports demonstrates that the majority of the airports that continue to be price monitored have continued to raise prices at a greater rate than is explained by their change in cost. It is noted that this analysis now can only be applied in relation to five airports (due to the reduction in the number of price monitored airports). However, Virgin Blue has concerns about the integrity of the information in relation to Sydney Airport and therefore is limited in its ability to apply this analysis to that airport.

The method that was applied to the information in the monitoring reports was as follows.

- First, the asset value that was disclosed in the ACCC's 2004/05 monitoring report and declared subsequently to be the 'line in the sand' value was compared to the asset value that was disclosed in the 2009/10 monitoring report (more specifically, the asset value that was calculated in an equivalent basis, labelled as the 'line in the sand' value by the ACCC). The change in the asset value was taken as a proxy for the investment undertaken over the intervening period. The efficient 'cost of capital' (see section 6.7) was then applied to this increase in investment to estimate the increase in the required return on assets for the airport.[17] Similarly, the change in depreciation and operating expenditure (net of depreciation) over the same period were also observed. The change in the required return on

[17] The efficient cost of capital of 10.2 % was a post tax 'vanilla' WACC. This has been converted to a pre tax nominal WACC for this analysis, which was 11.2 %.

assets, depreciation and operating expenditure were summed to estimate the increase in cost incurred.

- Secondly, the change in total costs derived using the above method was compared to the change in aeronautical revenue over the same period.

The results of this analysis are provided in Figure 13 below.

Figure 13 - Airport pricing and costs since the 2006 review

Adelaide	**2005/06**	**2009/10**	**% Change**
Revenue	46,243	83,841	81%
Total cost (opex weight = 40%)			7%
Operating expenses	*22,181*	*31,276*	*41%*
Asset value	*579,404*	*491,193*	*-15%*

Brisbane	**2005/06**	**2009/10**	**% Change**
Revenue	95,763	180,188	88%
Total cost (opex weight = 43%)			26%
Operating expenses	*45,899*	*70,320*	*53%*
Asset value	*920,917*	*973,841*	*6%*

Melbourne	**2005/06**	**2009/10**	**% Change**
Revenue	144,357	211,989	47%
Total cost (opex weight = 38%)			57%
Operating expenses	*56,994*	*79,060*	*39%*
Asset value	*497,486*	*832,961*	*67%*

Perth	**2005/06**	**2009/10**	**% Change**
Revenue	57,403	87,964	53%
Total cost (opex weight = 48%)			51%
Operating expenses	*30,071*	*44,267*	*47%*
Asset value	*181,287*	*279,680*	*54%*

Sydney	**2005/06**	**2009/10**	**% Change**
Revenue	335,140	489,869	46%
Total cost (opex weight = 28%)			26%
Operating expenses	*95,687*	*135,226*	*41%*
Asset value	*2,201,011*	*2,640,969*	*20%*

These results demonstrate that, for three of the four airports analysed, the sharp growth in the profit of the airports that was obvious prior to the Commission's last review has continued unabated in the time since, with only one of the airports (Melbourne) moderating their behaviour (albeit relative to the position at the time of the last review, as described above). Moreover, the hypothesis above that the results presented last time for Adelaide Airport's were distorted and that a sharp upswing in revenue growth was expected were borne out in the results.

As part of conducting the analysis set out above, Virgin Blue discovered what appears to be a discrepancy in relation to the 'line in the sand' asset value information for Sydney Airport. The non-current tangible asset value for Sydney Airport at the end of 2004/05

was $1.587 billion, which the ACCC subsequently endorsed as the 'line in the sand' value. However, between 2004/05 and 2005/06 this value increased by approximately $614 million (after a depreciation allowance of over $91 million), and this increment to the asset value formed part of Sydney Airport's 'line in the sand' asset value that commenced being reported from 2007/08 (in 2009/10 the line in the sand asset value was higher than the book value). In its 2009/10 monitoring report, the ACCC published a figure that attributes almost $600 million of the change in the 'line in the sand' asset value between 2004/05 and 2005/06 as due to 'AIFRS (aviation emergency services measures)', that is not arising from capital expenditure which was identified as contributing about $100 million to the upward movement in the asset values), disposals (immaterial for that year) or depreciation (which, at $91 million, almost offset the capital expenditure).[18]

This is good example of how difficult it is for airlines like Virgin Blue to assess whether the information provided by airports under the price monitoring scheme is reliable, accurate and consistent with the Aeronautical Pricing Principles. The need for improvements to the current Price Monitoring scheme is discussed in more detail in section 7.2.

Lastly, it is noted that the above analysis assumes that all of the costs incurred were efficient costs and so should be recoverable from airlines (and hence passengers). As discussed further below, Virgin Blue has substantial concerns about the efficiency of a number of the airports' capital expenditure.

6.5 Recent experiences of airport pricing

a) Airports have no incentive to find efficiencies

In Virgin Blue's experience, airports are able to continuously increase charges. These increased charges do not always reflect the efficient costs of operating the business. Because airports can simply recover their costs from airlines, they have little or no incentive to ensure that investments are efficient and projects are managed so as to minimise time and expense. This recovery of inefficient costs occurs both through the manipulation of the inputs into building block calculations of the rate of return (including the WACC, demand forecasts, taxation, asset value, capex and opex) (discussed in detail below) and through the pass through of additional costs which are bolted on to the contracted aeronautical charges. This results in double charging and inefficiently high costs which are borne by airlines to the detriment of consumers.

In other cases it is Virgin Blue's experience that some airports simply charge arbitrary, unreasonably high prices that bear little relationship with the actual cost of providing services. These are imposed with little explanation or supporting evidence.

Under the current approach to airport pricing, aeronautical charges increase year on year without airports having to account for the efficiency or reasonableness of such increases. While airlines must continuously find efficiencies in order to compete on price and service in highly dynamic and competitive aviation markets, airports have no incentive to do the same because they can simply pass on their costs.

Airports could not engage in this pricing behaviour absent their market power.

Examples in relation to specific airports are provided below.

[**CONFIDENTIAL**]

[18] ACCC, *Airport Monitoring Report 2009-10*, p 266 (Chart 8.1.8).

6.6 Limitations of the Building Block Model

Generally Tier 1 and Tier 2 airports adopt a building block methodology to calculate their rate of return and therefore the aeronautical charges to be applied in order to obtain that rate of return.

In Virgin Blue's experience, airports can and often do manipulate the inputs into this model in order to gain the maximum revenue, resulting in increased aeronautical prices. This can occur in relation to the following inputs:

- **Asset betas**: Virgin Blue considers that airports apply a much higher asset beta than that which would properly reflect the level of risk associated with their business. The experience of airports and airlines over the last 10 years, in particular during the GFC, has shown that airports are largely insulated from external shock events with airlines instead bearing the risk.

- **Indexation of asset/cash flows (pre-funding)**: Airports have used indexation (CPI) to increase asset bases and increase depreciation charges under the recovery model. This is not a cash expense and has included the claim for depreciation of land. Furthermore, a number of airports apply for recovery and indexation to capital expenses as a cash flow prior to any asset being put into service to benefit the consumer. Virgin Blue considers that this pre-funding is inefficient and unreasonable.

- **Useful life of assets**: Airports use a variety of useful lives for assets and when changes are made, a weighted average is reported without any detail provided. Little visibility or consistency in reporting appears to exist. In Virgin Blue's experience, some airports have begun to apply very short asset lives to enable depreciation over a much shorter period that does not accurately reflect the useful life of assets.

- **Recovery of taxation**: Taxation expenses generated by the airports are generally included in operating expenses and recovered from the airlines and consumers through aeronautical charges.

- **Passenger forecasts**: Airports continually apply lower passenger forecasts during pricing negotiations than would be reasonably forecast in the light of historical passenger numbers and forecast demand. By using low traffic forecasts, airports can divide their return over a smaller number of passengers, increasing the per passenger aeronautical charges. For example, if an airport has calculated its revenue at $10 million per annum, if it applies a passenger forecast of 700,000 passengers, the aeronautical charge would be $14. 28 per passenger while if it applies a traffic forecast of 1 million passengers, it will be $10. As a result of applying an artificially low passenger forecast, overall airport revenues are higher. The excess revenue obtained through the even recovery of charges through underestimation of traffic flows is rarely returned to airlines. This excess revenue has been seen in the significant recent increases in airport revenues.

In Virgin Blue's experience, the area with the most scope for manipulation is the calculation of the WACC, which is discussed further below.

6.7 Weighted Average Cost of Capital – Scope for manipulation

One of the areas in the building block calculation that is most open to being manipulated is the assumption about the Weighted Average Cost of Capital (**WACC**) and the associated assumption about the value of imputation tax credits to investors (the assumption for which is conventionally referred to as 'gamma').

There are two features to the WACC that provide both a strong incentive, and the capacity, to manipulate this assumption.

- First, the WACC assumption is highly material. As a 'back of the envelope' test, if the efficient WACC is 10 per cent, but the airport manages to raise it by 2 percentage points, this is likely to result in prices being 10 per cent higher than otherwise (that is, a 20 per cent rise in the WACC, with the 'return on assets' component typically making up 50 per cent of a building block revenue stream).

- Secondly, the WACC cannot be observed, but can only be estimated, and the theory and empirical evidence is such that the resulting estimates have substantial imprecision. Thus, the range for the WACC that typically result from mechanically applying statistical techniques can easily span values that would never motivate investment (at the lower end) to values that would deliver substantial monopoly rents.

The key implication of this second point is that if a WACC is to be used for pricing, it is essential for the estimates to be combined with (independent) judgement, drawing upon experience and other information, and not just involve a mechanical application of statistical techniques.

In Virgin Blue's experience, however, the airports tend to hide behind the statistical imprecision in WACC estimation and place the onus upon the airlines to disprove their proposed WACCs, which is an impossible task with the available information, except in the most extreme cases [**CONFIDENTIAL**]. This 'grey zone' provides the airports with substantial room to raise their prices and earn real life monopoly rents while simultaneously claiming that prices are efficient. Some of Virgin Blue's experiences are described next.

a) Weighted Average Cost of Capital – Virgin Blue's experience

Figure 14 has been prepared using Virgin Blue's recent experience with dealing with the airports over pricing. This table sets out the WACC inputs that airports have proposed, although it is noted that in some cases the airports have agreed to vary certain parameters during negotiations (albeit never as far as the efficient benchmark that is presented).[19] The table includes:

- *Risk free rate* – this is seldom a controversial issue, as the prevailing Commonwealth Government 10 year bond is generally proposed. Accordingly, this table recalculates all WACC estimates using the current bond rate to aid comparability.

- *Parameters open to manipulation* – the parameters most open to manipulation are provided in bold red.

- *Imputation benefit* – as noted above, it is standard in Australian regulatory practice to assign a benefit to dividend imputation credits. This normally enters the pricing model as an offset to the amount of company tax that is paid. An estimate has been provided here (converted to an equivalent change to the WACC) on the assumption that the effective and statutory rates of taxation are the same. [**CONFIDENTIAL**].

- *Additional cost against the efficient benchmark* – the effect of the difference between the airport's proposed WACC and the efficient benchmark on the airlines' costs is illustrated assuming a capital asset value of $500 million. For larger or smaller airports, the dollar cost would be proportionately higher or lower.

19 [**CONFIDENTIAL**]

b) The cost of debt

Recent examples of the manipulation of the cost of debt are discussed below.

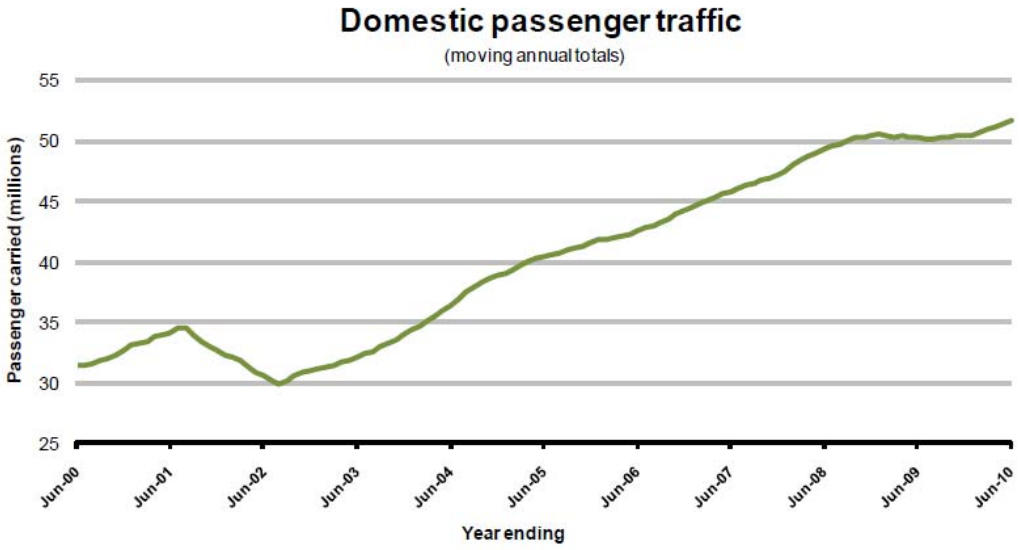
[**CONFIDENTIAL**]

c) Levels of risk and the appropriate asset beta

The asset betas that the airlines have proposed, as well as Virgin Blue's assessment of an efficient asset beta, can be tested against a first principles analysis of the risk of airport assets.[20]

Virgin Blue considers that it is airlines, and not airports, that bear the majority of risk for passenger numbers. The experience of airlines in the recent GFC, as well as following other external shock events such as terrorism, pandemics and natural disasters show that airports have remained relatively insulated while airlines have borne the risk. Because demand for airline services is relatively elastic and as a result of the economics of operating networks of aircraft, when demand drops airlines discount fares in order to stimulate demand and maintain load factors. The graphs below illustrate that, in the face of external shock events, passenger numbers have continued to grow while airfares have remained stable or reduced over time. Despite this, airports continue to apply an asset beta that reflects a high level of risk.

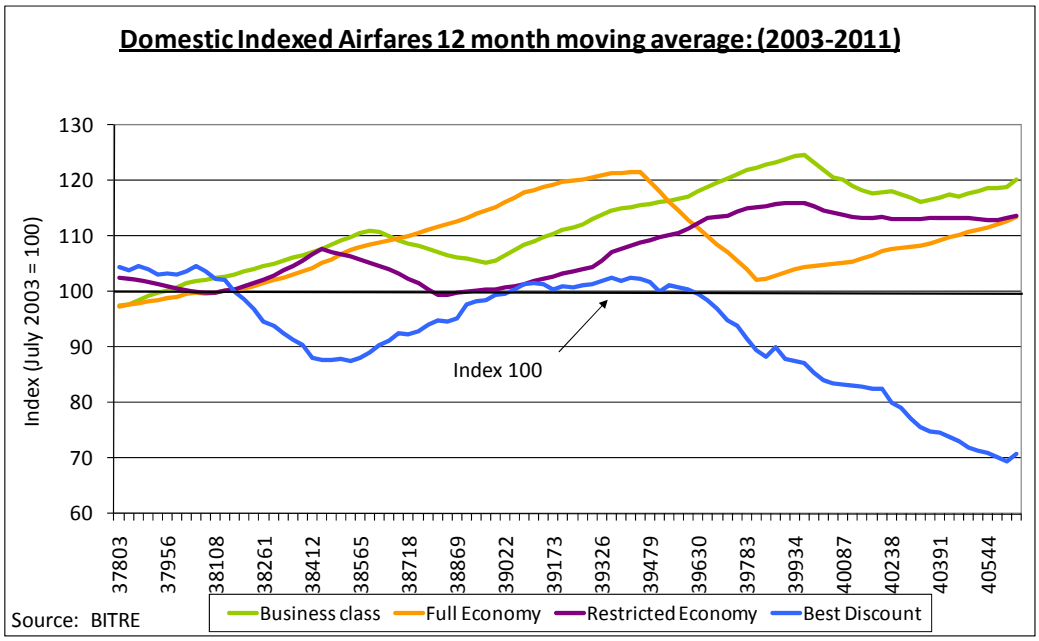
Figure 17 – Growth in domestic passenger traffic[21]



[20] The financial assets being compared in this analysis are the cash flows to the assets prior to financing. The beta that is associated with pre-financing cash flows is referred to as the asset beta.

[21] Bureau of Infrastructure, Transport and Regional Economics, *Domestic airline activity Annual 2009-10*, p 2.

Figure 18 – Domestic airfares over time[22]



The ACCC has concluded, in its *2009-10 Airport Monitoring Report*, that the risk to airports' aeronautical revenues is partly insulated from demand shocks, while risk is transferred to airlines. The reduced level of risk should be taken into account when determining whether airports are earning monopoly profits.[23]

The discussion above demonstrates conclusively that the risk of airport assets are materially lower than that of airlines and also materially lower than the average of the assets that are listed on the Australian share market. The asset beta for a diversified portfolio of Australian shares is approximately 0.70.[24] Thus, this first principles analysis provides strong support for the proposition that the airports' proposed asset betas overstate the true values, and that Virgin Blue's estimate of the efficient value is supported.

7 How effective is the current economic regulatory regime?

7.1 Overview

As part of the Inquiry, the Commission is considering:

- whether the existing regime is effective in appropriately deterring potential abuses of market power by airport operators;
- whether the existing range of remedies is effective in dealing with potential and suspected abuses of market power; and
- the effectiveness of the monitoring regime conducted by the ACCC, including the methodology used and the adequacy of the information collected.

---

22 Figure 18 shows the monthly domestic airfare indexes for March 2002 to March 2011. The graph illustrates the indexed fares for business, full economy, restricted economy and best discount classes. The original data set was obtained from BITRE, 2011.

23 ACCC, *Airport Monitoring Report 2009/10*, p 51-55.

24 The equity beta for the diversified portfolio of shares is 1 by definition, and the average level of gearing is approximately 30 per cent, implying an asset beta of 1 x 0.3 = 0.7.

Virgin Blue considers that:

- airlines cannot effectively commercially negotiate with major Australia airports except in cases where the airports have a special commercial incentive to do so;
- airports have been able to increase airport aeronautical charges above efficient levels and increases in charges have significantly exceeded increases in costs; and
- at the same time, services at airports have not generally improved or, worse, have deteriorated.

This demonstrates that the current economic regulatory regime is not effective in deterring potential abuses of market power. To the contrary, airports have been able to engage in monopoly pricing and related abuses of their market power.

This section discusses the limitations of the current price monitoring regime and the declaration provisions of Part IIIA of the CCA.

Interestingly, experience with Part IIIA of the CCA clearly demonstrates that:

- it is ineffective at constraining airports' market power due to the time, cost and uncertainty inherent in the declaration process;
- however, once an airport service has been declared, the resulting negotiate-arbitrate regime that comes into operation is very effective at resolving disputes and does not (as some had feared) result in any automatic resort to arbitration by airlines or airports.

7.2 Current monitoring regime

The fundamental problem with the current regime is that price monitoring alone will never be sufficient to constrain airports' market power and ensure that they provide services in an efficient manner and at appropriate prices.

For a price monitoring regime to work, there would have to be:

- far greater transparency of cost information provided by airports and a process to ensure the integrity of this information;
- far greater certainty as to the approach the Government expects airports to take in pricing aeronautical services than is currently provided by the *Aeronautical Pricing Principles*; and
- a credible threat of timely and effective sanctions from the Government in the event that an airport did not price in the expected way.

All three of these elements are missing from the current price monitoring regime.

Far too little information is provided in the price monitoring reports on a range of important topics (eg asset valuation and depreciation and cost allocation) and it is far too easy for airports to understate their actual financial returns, for example by inflating certain asset values.

Further, there is no credible threat of any effective sanction when airports abuse their market power.

For this reason, Virgin Blue has consistently argued for a regulatory approach that would give primacy to commercial negotiations between airlines and airports but still have

effective constraints on airports market power. This is the negotiate-arbitrate model that was recommended by Virgin Blue in its 2006 submission and is discussed in more detail below.

Virgin Blue considers that price monitoring would continue to fulfil a useful function under a negotiate-arbitrate model since transparency about airports' costs will greatly assist commercial negotiations. Virgin Blue makes a number of suggestions to improve the price monitoring function in section 10.

Given that Virgin Blue considers that price monitoring will continue to have a useful role to perform going forward, it offers the following general comments in relation to the current price monitoring reports. In its 2006 submission to the Commission, Virgin Blue identified a number of deficiencies in the price and quality monitoring reports as they then were. While a number of improvements have been made since that time, important issues remain:

- a key problem with the reports, and the price monitoring regime more broadly, that has been discussed at length over the years is that measuring profits is a meaningless exercise without having established proper asset values, particularly in the case of airports, for land. While the Commission's line in the sand approach to such asset valuations as recommended in its 2006 report does have the benefit of simplicity, it does not assist in exposing or addressing opportunistic revaluations of assets made by the airports in the period leading up to the line in the sand;

- there is little confidence in the figures presented in the price monitoring reports since there is no evidence that the figures presented by the airports have been subject to any independent investigation, scrutiny or verification;

- a range of other issues remain, such as:

    - the treatment of depreciation [**CONFIDENTIAL**];

    - the allocation of costs as between aeronautical and non-aeronautical services is not transparent; and

    - there is little detail provided about capex or opex undertaken by airports. While there are overall balance sheets from which it is possible to infer capex or opex, this requires a number of assumptions to be made, and there is no break-down of aggregate capex or opex into meaningful categories.

7.3 How effective is Part IIIA of the CCA?

a) Outline of Part IIIA of the CCA

Part IIIA of the CCA provides a general (as opposed to industry specific) access regime for access to what might be broadly described as monopoly infrastructure of national significance. Part IIIA applies to a potentially very wide range of infrastructure, from water and waste water infrastructure, to rail infrastructure as well as airports.

Part IIIA provides for a variety of different access mechanisms, including (relevantly) a negotiate-arbitrate model for access to 'declared' services.[25] A negotiate-arbitrate model is a light handed form of regulation that seeks to ensure that the primary method for determining the terms and conditions of access to the service is commercial negotiation between the access seeker and the access provider. Under a negotiate-arbitrate model,

[25] Part IIIA of the CCA also provides a mechanism under which an owner or operator of infrastructure can lodge an access undertaking with the ACCC which, if accepted by the ACCC, will prevent the relevant service from being declared. No airport has had an access undertaking accepted by the ACCC under Part IIIA of the CCA.

it is only if this commercial negotiation breaks down that parties have the right to have any dispute arbitrated, and even then the subject matter of the arbitration is limited to the terms and conditions over which the parties cannot reach commercial agreement.

Part IIIA of the CCA can therefore relevantly be seen to consist of two key parts:

- the declaration provisions, which are a gating mechanism to determine which services should be subject to the arbitration provisions; and

- the arbitration provisions, which allow for providers and users of the declared service to seek a determination from the ACCC in the event that commercial negotiations over the provision of the service are not successful (ie a negotiate-arbitrate regime for the declared service).

In relation to the gating mechanism, in order to be declared, a service must meet certain criteria set out in Part IIIA of the CCA. These criteria are:

- 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;

- that it would be uneconomical for anyone to develop another facility to provide the service;

- that the facility is of national significance, having regard to:

    - the size of the facility; or

    - the importance of the facility to constitutional trade or commerce; or

    - the importance of the facility to the national economy;

- that access to the service:

    - is not already the subject of a regime in relation to which a decision under section 44N that the regime is an effective access regime is in force (including as a result of an extension under s 44NB); or

    - is the subject of a regime in relation to which a decision under section 44N that the regime is an effective access regime is in force (including as a result of an extension under section 44NB), but the Council believes that, since the Commonwealth Minister's decision was published, there have been substantial modifications of the access regime or of the relevant principles set out in the Competition Principles Agreement;

- that access (or increased access) to the service would not be contrary to the public interest.

Further, in order to have a service declared, an access seeker must first apply to the NCC for a recommendation that the service be declared (s 44F). The NCC must make its recommendation to the relevant Minister on the basis of the criteria set out above (s 44G). The Minister will then make a decision whether or not to declare the service on the basis of the same criteria and having regard to the objects of Part IIIA and other matters set out in s 44H.

Both the access provider and the access seeker may apply to the Tribunal for a review of a decision by the relevant Minister to declare or not declare the service (s 44K). While Part IIIA of the CCA does not provide for any statutory right of appeal from the Tribunal's

decision, persons dissatisfied with the Tribunal's decision may seek judicial review of the Tribunal's decision under:

- s 39B of the *Judiciary Act 1903* (Cth);
- the *Administrative Decisions (Judicial Review) Act 1977* (Cth); and
- s 163A of the CCA.

Of course, declaration does not of itself result in access being granted on terms and conditions acceptable to both the access seeker and the access provider. However, if commercial negotiations fail in relation to a declared service, then either party may seek to have the matter arbitrated by the ACCC (s 44S).

It is important to note that the credible threat of an arbitrator making a binding decision in relation to a dispute can be a very effective mechanism in facilitating truly commercial negotiations between parties where there is a significant imbalance in market power.

If the threat of arbitration alone is not sufficient to resolve any dispute between the parties, then Part IIIA provides for the ACCC to hear and determine the dispute.

Following a final determination by the ACCC, any party dissatisfied with the determination has a right to apply to the Tribunal for a review of the determination (s 44ZP), and, under s 44ZR of the CCA, either party is entitled to appeal to the Federal Court from a decision of the Tribunal, but only on a question of law.

b) Application of Part IIIA in relation to the aviation industry

It has been previously acknowledged by the Government that airports are subject to the generic access provisions in Part IIIA of the CCA, and there have been two instances in which services provided by airports have been declared under Part IIIA. Sydney Airport was the relevant airport in both instances.

First, in *Sydney International Airport [2000] ACompT 1* (1 March 2000) (Sydney Airport) the Tribunal declared the following services provided by SACL:

- the service provided by the use of the freight and passenger aprons and the hard stands at Sydney International Airport for the purpose of enabling ramp handlers to load freight from loading equipment onto international aircraft and to unload freight from international aircraft onto unloading equipment.
- the service provided by the use of an area at Sydney International Airport for the purpose of enabling ramp handlers:
    - to store equipment used to load and unload international aircraft; and
    - to transfer freight from trucks to unloading equipment and to transfer freight from unloading equipment to trucks, at the airport.

Secondly, in *Re Virgin Blue Airlines* (2006) ATPR 42-092, the Tribunal declared the Airside Service, being:

> 'a service for the use of runways, taxiways, parking aprons and other associated facilities (Airside Facilities) necessary to allow aircraft carrying domestic passengers to:
>
> - take off and land using the runways at Sydney Airport; and

- move between the runways and the passenger terminals at Sydney Airport.'

On 18 October 2006, the Full Federal Court upheld the Tribunal's declaration of the domestic airside service (*Sydney Airport Corporation Limited v Australian Competition Tribunal* (2006) 155 FCR 124). Shortly afterwards, Sydney Airport sought special leave from the High Court to appeal the Full Federal Court's decision.

On 29 January 2007, Virgin Blue notified the ACCC of an access dispute with Sydney Airport in relation to the provision of the Airside Service.

On 2 March 2007, the High Court dismissed Sydney Airport's application for special leave to appeal from the Full Federal Court decision, stating that there were insufficient prospects of success.

On 22 May 2007, Virgin Blue withdrew its notification of the dispute having successfully negotiated a commercial settlement with Sydney Airport.

Following the very quick resolution of this dispute, neither Virgin Blue nor any other person notified any other dispute to the ACCC for the whole of the 5 year period in which the Airside Service was declared at Sydney Airport.

Virgin Blue believes that its experience with the Airside Service at Sydney Airport demonstrates three key points:

- first, that without an effective constraint on their market power, major airports will tend to exercise their power to the detriment of competition and the travelling public;

- secondly, that the declaration provisions in Part IIIA are not well suited to the task of constraining the market power of major airports, and suffer from a number of drawbacks as set out below; and

- thirdly, once an airport service is (eventually) declared and parties are able to resort to arbitration if necessary, disputes can quickly be resolved commercially without the need for a hearing before the arbitrator. The credible threat of arbitration encourages efficient commercial negotiation and does not result in parties needlessly seeking to arbitrate potential disputes.

c) Problems with relying on the declaration provisions of Part IIIA of the CCA

The problems with relying on declaration under Part IIIA of the CCA to constrain the market power of major airports stem from 3 sources:

- the time involved in an access seeker having relevant services declared under Part IIIA;

- the cost and expense in seeking declaration under Part IIIA, especially the cost that would be involved in seeking declaration of all airport services provided by all major airports where those airports have substantial market power; and

- the uncertainty attendant upon declaration given that some doubt exists currently in relation to the interpretation of the declaration criteria under Part IIIA following recent changes.

We discuss each of these problems in detail below.

(i) Time and cost involved in obtaining access under Part IIIA

The processes that an access seeker is required to follow in order to have a service declared are complex and lengthy, even with the time limits introduced in 2010.

As noted above, in relation to declaration alone there are potentially 4 separate decision makers to consider the matter: the NCC, the relevant Minister, the Tribunal and the Federal Court. Further, following declaration, if an access seeker and an access provider cannot agree on the terms and conditions for access then either can seek to have the ACCC arbitrate the dispute. The ACCC's determination in relation to any such arbitration may be the subject of an application to the Tribunal for review, and the Tribunal's decision may be the subject of a further appeal (on a question of law) to the Federal Court. Therefore, even once a service is (finally) declared under Part IIIA of the CCA, if parties cannot agree on the terms and conditions for access (which is a particular problem in negotiations where one party has a substantial degree of market power), then there can be substantial additional delays before access is provided on terms other than those imposed unilaterally by the service provider.

The amendments to Part IIIA of the CCA introduced to address criticisms about its operation in relation to the timing of the declaration process will not do enough to address this issue. These amendments introduced set timeframes for the various steps involved in declaration and arbitration as follows:

- 180 days for the NCC to make a recommendation following a declaration application (s 44GA);
- 60 days for the designated Minister to publish his or her decision in relation to declarations (following receipt of the NCC's recommendation) (s 44H(9));
- 180 days for the Tribunal to make a decision under any application for review (s 44ZZOA); and
- 180 days for the ACCC to make an arbitration determination on access disputes (s 44XA).

The NCC, the ACCC and the Tribunal are each permitted under Part IIIA to extend these timeframes in specified circumstances (called 'stopping the clock' in the CCA).

While the above timeframes are considerably shorter than those experienced by Virgin Blue in its application for declaration of the airside service at Sydney Airport,[26] the length of time, applying these timeframes, from an initial application to the NCC through to a binding determination of an access arbitration would still be unacceptably long for resolving an access dispute in a commercial context.

Further, the process under Part IIIA of the CCA is very costly for both access seekers and for access providers. In relation to the Airside Service at Sydney Airport, Virgin Blue has been represented throughout the process, including at three separate hearings (one before the Tribunal, one before the Full Federal Court and one before the High Court), and has had to provide lengthy submissions to the NCC (including expert economic reports).

[26] In that matter, the NCC process took 14 months and the Australian Competition Tribunal process took 22 months. In total, it took approximately 5 years from the time when Virgin Blue commenced its application for declaration of the Airside Service in October 2002 to the time when the High Court dismissed Sydney Airport's application for special leave.

(ii) Uncertainty attendant on declaration

In addition to the time and cost involved in obtaining declaration under Part IIIA of the CCA, there is still considerable uncertainty as to the outcome of the declaration processes under Part IIIA. Very few applications to have services declared have been successful.

In particular, there may be some doubt about whether all airport aeronautical services provided at all Tier 1 and Tier 2 airports in Australia (being those services in relation to which Virgin Blue considers the airports have substantial market power) would meet the criteria for declaration under Part IIIA of the CCA. Even though Virgin Blue's application for declaration at Sydney Airport was successful, this does not mean that other aeronautical services provided by Tier 1 and Tier 2 airports will automatically meet the criteria for declaration under Part IIIA of the CCA. This is due in part to the fact that the declaration of services must be considered on a case by case basis, looking at the particular features of the relevant service, the service provider and the relevant dependent market (which may alter from service to service and from airport to airport).

Although the Full Federal Court decision in *Sydney Airport Corporation Limited v Australian Competition Tribunal* gave the declaration criteria in Part IIIA their intended meaning (which did not present as high a barrier to declaration as some thought they should), certain legislative amendments to Part IIIA have been passed since that decision which will greatly increase the uncertainty as to whether all airport aeronautical services provided at all Tier 1 and Tier 2 airports in Australia could be the subject of a successful declaration application, including (as noted by the Commission in its *Issues Paper*):

- the recent changes to the declaration threshold in s 44H(4)(a) of the CCA which now requires that access (or increased access) would promote *a material increase in* competition in another market; and

- the objects clause (s 44AA) that has been introduced into Part IIIA.

d) Conclusion in relation to Part IIIA

In conclusion:

- declaration under Part IIIA is a very slow, costly, inefficient and difficult process by which to constrain the exercise of market power by airports;

- however, once a service is declared, the threat of arbitration by the ACCC appears to be a very effective inducement to parties to quickly and efficiently resolve disputes on a commercial basis.

(i) Declaration

The delay involved in obtaining declaration is itself a sufficient reason to discount its application, even with the new timeframes. This is in part because the earliest time for backdating any determination in relation to the terms and conditions for access is the date of declaration. It is quite likely that an airline will not want to go through the costly process of having services provided at a particular airport declared if it considers that it can obtain acceptable terms and conditions through commercial negotiation. However, if the airport subsequently refuses to offer acceptable terms and conditions, then the airline is in a very poor position because it could be a matter of years before the service is declared, and Part IIIA offers no remedy or compensation for any loss incurred by the airline in the interim as a result of the airport's exercise of market power. Therefore, if an airline waits until a problem arises in negotiations with an airport, it is already too late as any redress is years away (even if the service is successfully declared). Further,

because of the legal doubt attendant on whether a particular service will be declared under Part IIIA, there is a barrier to such disputes being settled commercially. Given that it is not possible to predict years in advance when a dispute with an airport may arise (and with which airport in relation to which service), it is not possible to proactively apply to have just those services declared under Part IIIA.

(ii) Arbitration

Importantly, once the tortuous path to declaration has been trod, and there is a credible threat of arbitration by the ACCC if the parties are unable to commercially agree on terms, then the evidence demonstrates that the arbitration provisions of Part IIIA can be very effective in constraining airports' market power and encouraging parties to negotiate and resolve disputes commercially.

We discuss the benefits of negotiate-arbitrate model further in section 10 below.

8 Land transportation and car parking

8.1 Overview

The ACCC's *Airport Monitoring Report 2009-10* has identified a number of concerns regarding potential monopoly pricing of car parking and other land transportation services at monitored airports, particularly at Melbourne, Sydney and Brisbane Airports.

As part of the Inquiry, the Commission is considering:

- Has the pricing behaviour of airports indicated the use of market power in car parking?
- Do the price increases reflect monopoly rent, locational rent (e.g accounting for the opportunity cost of alternative uses of land dedicated to car parking), or both?
- Are monopoly profits evident for short-term, long-term, or all forms, of parking?

8.2 Classification of aeronautical services results in inefficient pricing

Currently, car parking, retail and other services which are not 'necessary for the operation and maintenance of civil aviation' at airports are classed as non-aeronautical services. As a result, these services are therefore priced differently by airports and not subject to the same level of scrutiny as aeronautical services.

In Virgin Blue's experience, airports classify the inclusion of services as either aeronautical or non-aeronautical to ensure maximum profitability. For example, as discussed above, in some circumstances they attribute a very high proportion of investments to aeronautical services in order to recover costs through aeronautical charges. However, if airports consider the services would be highly profitable on a stand-alone basis, then airports class them as non-aeronautical so that they can price at any level they choose without the need to be accountable for those prices.

[**CONFIDENTIAL**]

Further, in Virgin Blue's experience, airports often engage in monopoly pricing in relation to services such as staff car-parking. Airline staff have little choice but to drive to work as most Australian airports are inadequately serviced by public transport connections and the working hours of many staff are outside the hours in which transportation is available. Airports are therefore largely unconstrained in their ability to charge high prices for services such as staff car parking and they take advantage of this position.

Virgin Blue considers that the simplest and most effective way to remove inefficiencies associated with this classification is to adopt a pragmatic approach to the definition of aeronautical services. As discussed in section 10 below, Virgin Blue considers that the definition should be expanded to include everything within a terminal (including retail) and all other services used by passengers in the course of travelling on airlines. This would still exclude retail and office space which is outside the terminal but built on airport land, such as has occurred at Brisbane and Canberra Airports.

9 Economic regulation of airports – international practice

9.1 Overview

The Government's Terms of Reference direct the Commission to examine international comparisons of the performance of airport operators. The Commission has stated in its *Issues Paper* that comparing charges, costs and rates of return at the price monitored airports with those at international airports may provide insights into the reasonableness of outcomes under the current regulatory system.

Virgin Blue has only recently expanded its international operations and, with the exception of New Zealand airports, it has limited experiences in negotiating with international airports. However, as Figure 1 reproduced in the Commission's *Issues Paper* shows, charges at Australia's largest airports are amongst the highest in the world when compared with international airports. This Figure similarly shows that charges at New Zealand airports are also amongst the highest in the world. Virgin Blue has experienced similar difficulties in negotiating with New Zealand airports and considers that in many cases their charges are unreasonable and inefficient.

Virgin Blue considers that an examination of international models for economic regulation of airports provides a useful comparison to the current Australian regulatory regime, particularly in the context of the relatively high charges imposed at Australian airports. Set out below is a comparative examination of regulatory regimes internationally.

Virgin Blue's research indicates that, with the exception of New Zealand, Australia is alone in its approach of having no regulatory pricing controls on airports. While both Australia and New Zealand maintain an airport reporting and monitoring regime, New Zealand has introduced input methodology requirements which increase the transparency of the airport pricing process and provide more accurate information which can be used by the New Zealand Commerce Commission in assessing the conduct of airports. As discussed in section 10 below, Virgin Blue submits that similar guidelines could be issued in Australia to improve the monitoring regime and facilitate transparency. An examination of international practice provides a number of potential features that could be introduced in Australia.

9.2 Summary

The table below sets out a summary of airport ownership and regulation in the United Kingdom, the United States, Canada, New Zealand and the European Union.

Figure 19 – Comparison of Airport Ownership and Regulation

Main airport ownership	Price regulation?	Type of price regulation	Other key regulatory features
United Kingdom			
Majority privately	Yes, for airports with an annual turnover	Includes price cap imposed by CAA, currently set as a cap on	Conditions may be attached to permission to levy airport charges,

owned.	of at least £1m.	the amount that can be levied by way of airport charges for a five year period.	including conditions to remedy or prevent adverse effects of anti-competitive conduct.
Canada			
Majority government owned by Transport Canada.	No. Currently airports must meet requirements under the Canadian Aviation Regulations in order to be issued an Airport Certificate.	N/A	N/A
United States			
Privately and publically owned; majority are publicly owned (including the major airports).	Yes Several federal laws provide economic regulation for airports.	Fees charged must be 'reasonable' and used only for airport or aeronautical purposes. A charge is 'reasonable' if it is based on an approximation of use of facilities, is not excessive in relation to benefits conferred and does not discriminate against inter-state commerce. *(Northwest Airlines v Vounty of Kent 510 US 355 (1994).* Department of Transport is of the view that rates and charges are best addressed at a local level by agreement between users and airports.	In order to receive federal funding, airports are required to be available for public use on reasonable conditions and without unjust discrimination. Airports should be as self-sufficient as possible. Under a privatisation pilot program, each airport fee must not increase faster than the rate of inflation unless approved by 65% of the air carriers.
European Union			
Varies by member state; both state owned and privately owned.	Yes, for airports with an annual passenger volume of 5m or more, or if no airport in a member state reaches that threshold, the airport with the highest passenger volume in the state. Each member state must implement the	No particular calculation method for charges is mandated; only charges for the use of airport facilities and services are covered. Airports must apply specific principles when determining airport charges, including non-discrimination and	Member states must put into place consultation procedures between airport managing bodies and airport users with respect to the level of airport charges. An independent supervisory entity must be set up to resolve

	regulation into their national law by 15 March 2011.	transparency.	disagreements.
New Zealand			
Private airport companies.	Airports are only regulated in respect of information disclosure requirements. There is no regulation as to pricing. Following consultation, the New Zealand Commerce Commission has determined input methodologies that must be used by airports in financial reporting in response to the information disclosure requirements.	N/A	Airport companies must consult with their substantial airline customers before setting or changing their charges.

9.3 United Kingdom

As in Australia, the United Kingdom has undertaken privatisation of airports. The United Kingdom has a wide-ranging regulatory regime, imposed under the *Airports Act* 1986 (**UK Airports Act**). Its core provisions relate to the ability of the Government to 'designate' airports, which are then susceptible to price regulation.

Airports with an annual turnover in excess of £1m may not levy airport charges unless they have permission to do so from the Civil Aviation Authority (**UK CAA**). Airport charges are, under s 36 of the UK Airports Act, charges levied on operators of aircraft in connection with the landing, parking or taking off of aircraft at the airport (including charges that are to any extent determined by reference to the number of passengers on board the aircraft, but excluding certain charges payable pursuant to provisions of the *Transport Act* 2000) and charges levied on aircraft passengers in connection with their arrival at, or departure from, the airport by air.

Once permission to levy charges has been granted, the UK CAA may impose conditions to regulate the conduct of the airport in relation to its users.[27]

In addition, the UK CAA imposes price caps for a 5 year period on airports designated by the Secretary of State. Heathrow, Gatwick and Stansted airports are currently designated. Although the Government did not give reasons for designating these airports in 1986, the Government has subsequently set out criteria it will consider, deeming it appropriate to designate an airport if:[28]

[27] In its most recent decisions regarding price control and regulation at the designated airports, the UK CAA has imposed conditions on the designated airports in relation to users.

[28] CAA's advice on the Future Regulation of Manchester Airport, July 2007.

- the airport, either alone or together with any other airport(s) in common ownership or control, has or is likely to acquire substantial market power; and

- domestic and EC competition law may not be sufficient to address the risk that, absent regulation, the airport would increase and sustain prices profitably above the competitive level or restrict output or quality below the competitive level; and

- designation under the UK Airports Act would, taking into account the magnitude of the risk identified in (b) and its detrimental effects were it to materialise, deliver additional benefits (i.e. over and above competition law) which exceed the costs and potential adverse effects of price regulation (i.e. the incremental benefits are positive).

In reaching a decision to designate (or de-designate) an airport, the Government will take into account all other relevant matters, including international obligations.

The process for the imposition of price controls is, in general terms:[29]

- the UK CAA formulates price control proposals and conducts public consultation;

- the UK CAA makes references to the Competition Commission, submitting price control proposals and specifying whether any courses of conduct by airport operators in relation to airport charges, operational activities carried out by the operator or the granting of rights by which others may carry out operational activities since the date of the previous reference operate or might be expected to operate against the public interest;

- the Competition Commission conducts an investigation into the appropriate price caps and whether any of the airports has pursued a course of conduct that is contrary to the public interest;

- the Competition Commission reports to the UK CAA on the price caps and, where the Competition Commission finds that an airport operator has pursued a course of conduct which has operated or might be expected to operate against the public interest, the CAA must impose conditions that will remedy the adverse effects of the conduct;

- the UK CAA publishes the Competition Commission's report, the price cap and any public interest proposals and conducts public consultation;

- the UK CAA publishes its decision, following which the new price caps and any public interest conditions take effect.

The UK CAA has set the current price caps as caps on the average yield per passenger departing from the relevant airport, with a small proportion of revenues at Gatwick and Heathrow tied to specific service and investment performance. The UK CAA has also imposed a number of conditions where conduct has been found to be against the public interest.

The CCA has completed its fifth five-yearly review and published its economic regulation decisions for Stansted airport (2009-2014) and Heathrow and Gatwick airports (2008-2013).

9.4 Canada

In Canada, most airports are operated by Transport Canada and managed by Canadian Airport Authorities. Around 95% of air travellers in Canada are handled as part of a

[29] See eg CAA, 'Airports Review – policy update', 15 May 2006, p 2-3, 11-12.

policy known as the National Airports Policy (**NAS**). There are currently 26 NAS airports, including airports in all national, provincial and territorial capitals, as well as airports with annual traffic of 200,000 passengers or more.

The relevant legislation is the Aeronautics Act 1985 (**Aeronautics Act**) and the Canadian Aviation Regulations (**CARs**) made under the Aeronautics Act, The Aeronautics Act provides that the Governor in Council may make regulations (currently the CARs) imposing charges for the use of any facility or service provided by or on behalf of the Minster for or in respect of any aircraft, whether or not the facility or service is provided during the flight, whether the flight originates or terminates in Canada or whether any portion of the flight is over Canada. The CARs impose charges for a range of aircraft related matters and air operator certificates, however neither the Aeronautics Act nor the CARs provide for price regulation of airports. Thus, Canada does not have price regulation in place (or include 'system'/regime etc).

Various Bills to amend the Aeronautics Act with respect to price regulation have been put forward, however none of these have been passed.

9.5 United States

Airports in the United States are privately and publicly owned, however the majority of airports that significantly contribute to air traffic are publicly owned and operated. Generally, a county, municipality or sub-governmental entity owns or licenses the public airports.

In 1995, the Department of Transport issued a policy capping airport charges by requiring them not to charge any more than was required to break even. Under this policy, refunds were ordered of certain airport fees that were determined to be excessive.

Under the Department of Transports' current Policy on Airport Rates and Charges (**Policy**), it is made clear that '[i]t is the fundamental position of the Department that the issue of rates and charges is best addressed at the local level by agreement between users and airports'[30]. Direct negotiation between these parties is encouraged, so as to minimize the need for direct Federal intervention to resolve differences over airport fees. The Policy largely reflects the legislative requirements, set out below.

a) Economic regulation through legislation

There are several federal laws which provide for the economic regulation of airports in the United States.

The Anti-Head Tax Act 1973 permits state and local governments to collect 'reasonable' rental charges, landing fees and other service charges from aircraft operators for using facilities owned or operated by that state. Additionally, the Airport and Airway Improvement Act 1982 implements a fee and rental structure that makes airports as self-sustainable as possible, insisting that charges be reasonable and used only for airport purposes. Further to this, in order to receive federal funding, airports are required to promise that they will be available for public use on reasonable conditions and without unjust discrimination. The Federal Aviation and Administration Authorisation Act 1994 requires that airport charges, fees or taxes must be used for airport or aeronautical purposes only.

The US Supreme Court has held that a charge is reasonable when; it is based on some fair approximation of the use of the facilities, it is not excessive in relation to the benefits conferred, and it does not discriminate against inter-state commerce. The Department of Transportation has the authority to set aside 'unreasonable' fees. When the City of Los

[30] Department of Transport, *Current Policy on Airport Rates and Charges*, 8 July 2008.

Angeles, as the operator of Los Angeles Airport, sought to impose fees that would recover its opportunity cost of using the land on which the airport is located as an airport, various airlines challenged the fees on the basis that they was unreasonable, and the Department of Transportation found that they were. The City of Los Angeles challenged that finding.

The US DC Circuit Court of Appeals found that the City of Los Angeles was not entitled to recover the opportunity cost of using the land as an airport.[31] In rejecting an appeal by the City of Los Angeles Justice Silberman stated:

'…the issue might properly be described as whether LAX, having taken taxpayer money under the condition that it would continue to use LAX as an airport is legally entitled to charge a significant group of those taxpayers, airline passengers flying in and out of LAX, its opportunity cost based on a nonexistent opportunity'.

b) Airport Privatisation Pilot Program

In 1997 an Airport Privatization Pilot Program (the **Program**) was established and the Federal Aviation Authority (**FAA**) called for applications, intending that 5 airports would participate in the scheme. As part of the pilot program, airports were to be released from the obligation to use airport revenues solely for airport purposes. On pricing, the pilot program required that each airport fee imposed on an air carrier would not increase faster than the rate of inflation, unless a higher fee were approved by 65% of the air carriers serving the airport.[32]

Initially interest was limited and ultimately only one airport, Stewart International Airport in the Hudson Valley, was approved for privatisation. It has since become the first privatised airport in the US, under a 99 year lease from the New York State Department of Transport, and is subject to the pricing restrictions required during the application process. In September 2006, the City of Chicago submitted a preliminary application for Chicago Midway International Airport, a large hub airport. As the Program can only include one large hub airport, applications for other large hub airports were places on a standby list. As at 25 October 2010, there were four active applications for the Program.

9.6 European Union

In March 2009, the European Union (**EU**) adopted Directive 2009/12/EC on Airport Charges (the **Directive**). The Directive had to be implemented in all Member States by 15 March 2011 and applies to all EU airports open to commercial traffic which handle more than 5m passengers annually and to the largest airport in each Member State. An airport charge is that which relates to landing, take-off, lighting and parking of aircraft and processing of passengers and freight. The Directive does not apply to charges collected for the remuneration of en route and terminal air navigation services or charges collected for the remuneration of ground-handling services.

The Directive builds on and is complementary to the policies on charges for airports drawn up by the International Civil Aviation Organization. The main objectives and provisions of the Directive are as follows:

- greater transparency – on the costs covered by the airport charges. Airports will be obliged to share a detailed breakdown of costs with airlines in order to justify the calculation of airport charges;

---

31 *City of Los Angeles v US Department of Transportation* 165 F. 3d 972 (DC Cir 1999); petition for rehearing denied 179 F. 3d 937 (DC Cir 1999).

32 US Department of Transportation and the FAA, 'Report to Congress on the Status of the Airport Privatization Pilot Program', August 2004.

- non-discrimination – airlines receiving the same service will pay the same airport charge. However, airports will be able to differentiate their services, provided the criteria for doing so are clear and transparent. Airports will also be able to vary charges on environmental grounds (e.g. lower charges for more environmentally friendly aircraft);

- mandatory consultation – on charges between airports and airlines. Airports will also be required to consult with airport users before plans for new infrastructure projects are finalised;

- dispute settlement – Member States will be required to designate or set up an independent supervisory authority whose job will be to assist in settling disputes over charges between airports and airlines.

9.7 New Zealand

New Zealand's major airports have been privatised.

From 1986 until 2008, the *Commerce Act 1986* (NZ) (**Commerce Act**) contained generic provisions which provided for the Commerce Commission to undertake inquiries into whether particular goods or services should be subject to 'price control' (comprising control of prices, revenues and/or quality standards). No price control was ever imposed on airport services.

Since 14 October 2008, airports have been subject to regulatory provisions under the Commerce Act. Specified airport services are defined in Commerce Act and include aircraft and freight activities, airfield activities and specified passenger terminal activities. Airports are only subject to information disclosure obligations. They are not subject to price controls. However, the Commerce Act provides for the setting of input methodologies that must be used by airports in reporting their costs and prices. The Commerce Commission had to determine input methodologies for regulated goods or services (including airports) no later than 30 June 2010. Each input methodology must be reviewed by the Commerce Commission no later than 7 years after its date of publication and subsequently at intervals of no more than 7 years.

The Commerce Act requires the Commerce Commission to report to the Ministers of Commerce and Transport as to the effectiveness of information disclosure regulation for specified airport services as soon as practicable after 2012.

---

10 Future arrangements: Virgin Blue's recommended model

10.1 Introduction

As discussed above in this submission, the monitoring regime and the knowledge that a report of the outcomes will be publicly released does not appear to be an effective mechanism to constrain the use of airports' market power. Further, the declaration process under the general access regime in Part IIIA is a slow, costly, inefficient and uncertain process. Therefore, Virgin Blue does not consider that the existing regulatory approach is effective in deterring abuse of market power by major airports.

As a possible alternative approach, the Commission's *Issues Paper* refers to the possibility of more heavy handed price regulation. Virgin Blue does not consider that such a response is necessary or appropriate, and instead considers that far greater benefits would flow from the regulatory approach proposed below, which essentially amounts to the introduction of a negotiate-arbitrate model for the relevant services at major airports.

10.2 Overview of Virgin Blue's proposed model

a) Virgin Blue's preference for commercial negotiation

Virgin Blue has consistently stated that its preference is to commercially negotiate agreements with airports. Commercial negotiation is the most efficient and flexible method of setting the terms and conditions on which airports supply, and airlines acquire, airport services.

However, as noted above in section 5, negotiations between (at least) major airports and airlines have rarely been conducted on a truly commercial basis. This is due in part to the market power that major airports possess in supplying aeronautical and related services.

Therefore, an incentive is needed to encourage airports to negotiate commercially in relation to the supply of these services. Virgin Blue believes that the best way to retain the efficiency and flexibility of commercial negotiation whilst providing an incentive for airports to negotiate 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.

Virgin Blue's experience with the declared Airside Service at Sydney Airport, where it was able to quickly and commercially resolve its dispute once the threat of arbitration became available, has confirmed its belief in the benefits of this model.

Virgin Blue has also proposed a new definition for aeronautical related services, as set out below. It recommends the Commission consider this new definition as a measure that could be implemented even independent of the negotiate-arbitrate model proposed.

10.3 Key features of Virgin Blue's proposed model

Virgin Blue proposes a light handed negotiate-arbitrate model (**Proposed Model**) with the following features:

- the model would apply to **aeronautical related services** provided at **major airports** in Australia, where:
    - aeronautical related services extend beyond the current regulatory definition of aeronautical services to include all services provided within a terminal and all other services used by passengers travelling on airlines; and
    - major airports are the following Tier 1 and Tier 2 airports: Sydney Airport, Melbourne Airport, Brisbane Airport, Perth Airport, Adelaide Airport, Canberra Airport, Darwin Airport, Gold Coast Airport, Hobart Airport and Cairns Airport;
- first and foremost, airlines and airports would be encouraged to commercially negotiate for the provision of airport services;
- in the event that the parties could not agree on the terms and conditions for the supply of aeronautical related services, users and providers would have the ability to refer the dispute to independent arbitration;
- in order to assist commercial negotiations and reduce the need for any arbitrations:
    - pricing and costing guidelines would be issued addressing key issues in negotiations over the provision of aeronautical related services; and

- the price monitoring regime would continue (with improvements) to ensure that airlines and airports have up to date, accurate and transparent information about airports' costs and prices.

Virgin Blue notes that this is very similar to the negotiate-arbitrate model that it proposed to the Commission in 2006.

This negotiate-arbitrate model could be introduced without the need for major legislative reform.

Virgin Blue considers that such a regulatory model would have significant benefits for the industry as it would lead to fully informed commercial negotiations between major airports and airlines and any resort to arbitration would be minimised through the provision of costing and pricing guidelines which would provide the parties with greater certainty as to the outcome of the arbitration.

The arbitration process should also provide for interim determinations and backdating of final determinations to ensure that there are no commercial benefits to any party from delaying the arbitration process.

10.4 Aeronautical Related Services

As mentioned in section 8 above, it is Virgin Blue's experience that airports can manipulate the allocation of services as either aeronautical or non-aeronautical to ensure maximum profitability, eg:

- in some circumstances airports attribute a very high proportion of investments to aeronautical services in order to be able to recover costs through aeronautical charges;

- in other circumstances, airports class services that they consider to be highly profitable on a stand-alone basis as non-aeronautical. Because of this, airports can price these services at any level they choose without the need to be accountable for those prices. [**CONFIDENTIAL**]

Virgin Blue considers that the simplest and most effective way to deal with this problem is to adopt a pragmatic approach to the scope of services covered. Adopting too narrow a definition would simply result in airports seeking to recover revenue that they cannot obtain from the defined services from other services which are required by airlines in order to provide civil aviation services at the airport.

Therefore, Virgin Blue proposes that the relevant services for the Proposed Model should be aeronautical related services, which would include everything within a terminal, including retail, and all other services used by passengers travelling on airlines. This would include the services provided by airports in which airports have market power. This definition would include things like public car parking and staff car parking, but would exclude retail and office space which is outside the terminal but built on airport land, such as has occurred at Brisbane and Canberra Airports.

The expanded definition should also include services provided by airports to third party suppliers to airlines. Monopoly charges levied on such third party suppliers (eg fuel companies, caterers) are inevitably passed on to airlines through increased prices.

10.5 Identity of the arbitrator

Given the issues that are likely to be involved in any dispute over the provision of aeronautical related services (eg asset valuations, the impact of charging structures,

efficiency of pricing levels), Virgin Blue considers that the ACCC would be well placed to conduct the independent arbitrations due to its:

- general experience in conducting arbitrations in relation to disputes over access to monopoly infrastructure; and

- specialised experience in relation to the pricing of aeronautical services through the price monitoring work that it does and the work that it performed under the previous price notification and price cap regime.

Virgin Blue notes that if the ACCC were to be the chosen arbitrator, then it may be possible to implement Virgin Blue's proposed negotiate-arbitrate model though the deemed declaration of aeronautical related services at major airports.

However, Virgin Blue would also be satisfied if the independent arbitrator under the proposed model was to be another person or body, so long as they satisfied the key criteria of independence and relevant experience.

10.6 Pricing and Costing Guidelines and improved Price Monitoring

a) Pricing and Costing Guidelines

While the threat of arbitration may be a significant incentive for parties to negotiate commercially, if the ACCC were to issue guidelines addressing key costing and pricing issues, then parties would be better informed about the likely outcome of any arbitration. This additional certainty would assist in negotiating commercial outcomes without the need for formal arbitration.

In relation to airports, Virgin Blue considers that guidelines prepared by the ACCC on the following issues would greatly assist parties in commercial negotiations:

- the valuation of airport assets, including:
  - how an initial asset value should be determined;
  - how that value should be adjusted over time, including guidance on depreciation rates and whether the asset value should be indexed for inflation;
  - the time at which charging should commence for new increments to capacity;
- the allocation of costs between aeronautical and non-aeronautical services and other cost measurement issues; and
- the parameters or methods for estimating the WACC that the ACCC considers would be appropriate.

These are discussed in turn below.

(i) Asset valuation

Initial asset value

As the Commission recognised in its previous review, the method by which assets may be valued is important to pricing, but equally controversial, given the absence of definitive guidance from economic principles. Requiring the ACCC to 'lock in' a starting value under the new regime would therefore remove a substantial barrier to prices being negotiated commercially.

Given the importance of this matter to the level of prices that would be determined for aeronautical services in the future, Virgin Blue considers it appropriate for the starting values be determined by the ACCC after conducting an open and transparent review, with consultation with the airlines and airports.

Adjustment to the asset value over time

Once an initial asset value has been determined, the process for carrying this value forward is much less controversial. Nonetheless, there are a number of matters where clarity upfront would substantially improve the prospects for successful negotiation, which include the following:

- *Default asset lives and depreciation method* – the guidelines should specify a default for asset lives and the depreciation method, while also permitting airports and airlines to agree to alternative lives or depreciation method where required by the specific circumstances of the airport. The standard depreciation method should be straight line depreciation (provided this is combined with CPI-indexation of the asset value, discussed next) and with the default asset lives (for which the ACCC should specify a table of values) reflecting the ACCC's view of the expected technical lives of the assets.

- *Indexation for CPI inflation* – it is almost universal in the regulatory regimes for infrastructure in Australia that asset values are indexed for CPI inflation over time. This has the dual effects of creating a smoother (and more allocatively efficient) time path for prices over time, while protecting airports from unexpected inflation risk. The same approach should be applied in relation to airports. It is noted that when asset values are indexed for inflation, then either a real rate of return should be provided in the asset value (rather than a conventional nominal rate of return) or, equivalently, the indexation gain should be treated as an offset to the revenue that prices are set to recover.

Treatment of assets purchased or being constructed for future use

As discussed elsewhere in this submission, a number of airports have sought to commence recovering the cost of assets in advance of those assets entering into service and being required for use. In relation to new runway developments, this could imply starting to charge for an asset almost a decade before any service is provided. Virgin Blue notes that charging for a non-existent asset could not be sustained in a competitive market, and also raises issues of equity between the current (subsidising) and future (subsidised) generations of passengers.

Accordingly, the guidelines should provide direction on how such assets should be treated for pricing purposes which, in Virgin Blue's view, implies leaving these assets out of the pricing equation until they have entered into service. Virgin Blue acknowledges that airports should have the opportunity to recover the efficient financing costs foregone during the construction period, although care would be required to ensure that incentives remained for only efficient new projects to proceed and then to be delivered in an efficient manner.

(ii) Measurement and allocation of costs

Virgin Blue notes at the outset that the problem of cost allocation discussed here would be largely addressed if the expanded definition of aeronautical related services was adopted. However, this problem would still be worth addressing in guidelines especially if the definition of aeronautical and non-aeronautical services remained unchanged.

An important step when calculating aeronautical charges is to ensure that assets associated with non-aeronautical activities are excluded, and that the cost associated with shared assets or expenditure items are allocated between aeronautical and non-aeronautical activities on a fair and reasonable basis. It is noted in this regard that the oft-espoused 'outer bounds' for cost allocation – namely between incremental and stand alone cost – provide insufficient guidance. It would be appropriate for the guidelines to provide practical directions on the segregation and allocation of costs.

Further, the guidelines also should require the costs to be allocated between the different aeronautical services in a manner that is most relevant to the way in which those services are priced. This would imply that cost should be allocated at least between terminals and runways and associated infrastructure (given the normal situation whereby separate landing and terminal charges are negotiated), but also disaggregated further if more unbundling of pricing occurs (for example, if a separate charge is levied for refuelling infrastructure).

(iii) WACC parameters and methods

Notwithstanding the extensive number of regulatory decisions on the WACC, the assumptions that airports adopt for this parameter continues to be a source of extensive controversy. The main reason for this continued controversy is that, while the WACC that is assumed for pricing purposes has a significant effect on the calculated prices, the standard techniques for estimating a WACC deliver an estimate with imprecision. Combined with this, the existing regulatory precedent does not eliminate the room for debate because:

- for the industry-wide assumptions that are required to estimate a WACC, different regulators have adopted different assumptions and different times, which provides an opportunity for 'cherry-picking'; and

- there is an absence of recent Australian regulatory precedent on the asset beta, which is the most important industry-specific input assumption required, and again this is measured only with imprecision.

Accordingly, the guidelines could narrow the room for controversy significantly if the guidelines set out both the ACCC's view on the default set of industry-specific WACC inputs (together with a statement about the overall method to be applied) and the ACCC's view on what it considers to be an appropriate asset beta for aeronautical services.

b) Improved Price Monitoring

For the reasons set out in section 7 above, Virgin Blue does not consider that the current price monitoring regime is effective.

Virgin Blue considers that the ACCC price monitoring reports should provide a thorough and detailed analysis of prices, costs and profits, rather than merely comprising information provided to it by airports. In addition, those costs need to be measured and returns reported in a manner that is consistent with the purpose of monitoring, which would be to assist airlines and airports to engage in fully informed commercial negotiation. Therefore, the reports should involve more substantive analysis from the ACCC.

In order to improve the operation of the price monitoring regime, Virgin Blue recommends the following changes:

- the ACCC should adopt benchmarking measures for use in assessing airport operating costs and charges, so that trends can be monitored;

- the ACCC should distinguish between charges for domestic and international activities. This would allow an analysis of trends in domestic and international related charges, costs and profits;

- the ACCC should investigate (and comment in more detail on) the allocation of airports' costs to aeronautical and non-aeronautical services. Under a dual till regulatory structure there is a strong incentive for airports to over-allocate costs to aeronautical services so as to justify higher price levels for aeronautical services;

- the ACCC should monitor charges for particular aeronautical and related services. Currently, the ACCC only considers overall aeronautical charges, so that comparisons can be made between airports on a charge per passenger basis. However, many activities undertaken at airports are not passenger based, for example, take off and landing and refuelling; and

- the ACCC should complete its monitoring reports in a timely manner. At present, there can be a substantial lag following the end of the financial year in which a charge is introduced before the ACCC monitoring report is released.

10.7 Virgin Blue's Proposed Model will not result in excessive arbitration

The Commission has previously expressed a concern that if an airport-specific negotiate-arbitrate model were introduced, parties would view arbitration as the default process for setting prices (see, for example p 91 of the Commission's 2006 report).

However, as Virgin Blue has previously pointed out, a well-designed negotiate-arbitrate model can have the opposite effect and actually enhance the environment for commercial negotiations.

Since the Commission's 2006 report, there have been developments that allay the Commission's concerns and demonstrate how a negotiate-arbitrate model can enhance commercial negotiations. The experience with the declared Airside Service at Sydney Airport has been salutary.

The original dispute between Virgin Blue and Sydney Airport that led to the application for declaration was resolved by negotiation between the parties a matter of weeks after the final avenues of legal appeal against the declaration of the relevant service had been exhausted by Sydney Airport.

Further, there were no other disputes notified to the ACCC in relation to the Airside Service for the 5 year period it was declared. Clearly declaration did not lead to a situation where parties preferred arbitration to commercial negotiation. If this was the case in relation to the major aeronautical service at Sydney Airport, Virgin Blue cannot see any reason why the same position would not apply for other aeronautical related services at other major airports.

The background to any negotiate-arbitrate regime is that if parties behave in a reasonable, commercial manner, there need be no arbitration. This is the ideal situation and Virgin Blue's preferred approach to the negotiation of terms and conditions for the provision of aeronautical related services. The aim of arbitration is to act as a 'circuit breaker' in the event that commercial negotiations fail (and it may be necessary on rare occasions to resort to such a circuit breaker). However, the conduct of arbitrations is not

the only valuable element of such a regime. It is the *threat* of arbitration that would provide parties with an incentive to negotiate on a reasonable, commercial basis.

Terms and conditions of access negotiated on a commercial basis have clear benefits over an outcome determined by arbitration, including:

- certainty of outcome, as terms are agreed by the parties. This also gives the parties the potential to negotiate flexible terms and conditions;
- speed of outcome, as even the most efficient arbitration processes take time; and
- cost savings, as costs associated with arbitration are avoided.

The Commission has previously acknowledged the benefits of a negotiate-arbitrate model. For example, in its review of the National Gas Access Regime, the Commission stated:[33]

> 'In certain circumstances, an effectively designed negotiate–arbitrate framework can encourage commercial negotiation and innovation, and reduce regulatory compliance costs relative to the Gas Access Regime, while still providing a regulatory mechanism to prevent service providers from attempting to deny access to, or extract monopoly rents from, access seekers. For large users, there are benefits from greater flexibility in the terms and conditions of access that can be achieved through commercial negotiations.'

In addition, the publication of pricing and costing guidelines, as discussed above, would provide guidance to both the access seeker and the access provider as to the likely arbitrated outcome. This would provide an incentive to negotiate without resorting to arbitration, while limiting the access provider's ability to exercise any monopoly power, knowing that if it were to do so the access seeker would likely resort to arbitration. The Commission acknowledged the effect of pricing principles in its review of the National Access Regime:[34]

> 'Without pricing principles, negotiation can be somewhat unguided – at least until such time as arbitrated precedents are established. This could take a long time. From this perspective, pricing principles would be a particularly important adjunct to speedy negotiation during the early stages of an access regime.'

In conclusion, Virgin Blue considers that any concerns that a negotiate-arbitrate model may lead to excessive arbitration are misplaced. Given the absence of any other identified constraint, a negotiate-arbitrate model of the sort proposed by Virgin Blue offers the best outcomes for airports, airlines, the travelling public and society as a whole.

---

[33] Productivity Commission, *Review of the Gas Access Regime*, Productivity Commission Inquiry Report No 31, 11 June 2004 at p 335.

[34] Productivity Commission, *Review of the National Access Regime*, Productivity Commission Inquiry Report No 17, 28 September 2001 at p 201.