Virgin Australia Submission to the Competition Policy Review

17 November 2014

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1 Introduction

Virgin Australia welcomes the opportunity to contribute to the Competition Policy Review. Virgin Australia agrees that an effective competition framework is a vital element of a strong economy that drives continued growth in productivity and efficiency, for the benefit of both businesses and consumers.

Virgin Australia has always sought to bring more competition to the domestic and international aviation markets – from its earliest days as low cost carrier, Virgin Blue, to its more recent Game Change initiatives in which it has successfully built a full service airline with which to challenge Qantas for a share of premium and corporate travel. Virgin Australia has grown significantly since its entry into the Australian market and consumers have benefited from the resulting increase in competition and choice. In the course of building a competitive Australian airline, Virgin Australia has come up against some regulatory and competition law hurdles. For the most part, Virgin Australia has successfully worked within the legal and policy framework, however there are a number of barriers that persist and create inefficiencies, raise costs, and act as a barrier to competition.

This submission addresses some of the key regulatory impediments faced by Virgin Australia in building and operating a competitive Australian airline. Further, there are a number of aspects of the competition law which are uncertain or are out-dated. These serve to increase legal and compliance costs associated with common business practices such as dual distribution models, particularly the use of online booking tools, and consumer offers such as frequent flyer and other awards programs. Improvements to the competition law would reduce costs, create greater certainty and allow businesses to more easily offer consumers choice and enhanced services. In particular we make the following observations:

Improving Competition Laws

1 The per se prohibition against third line forcing creates unnecessary compliance burdens and adds to business costs, in circumstances where the overwhelming majority of third line forcing notifications are allowed to stand on public benefit grounds. Section 47 of the *Competition and Consumer Act* 2000 (**CCA**) should be amended to make third line forcing subject to the same substantial lessening of competition test that applies to other forms of exclusive dealing.

2 More generally, supply arrangements (including between firms and their distributors, and firms and their customers or suppliers) should not be subject to the cartel offences under the CCA. Recognising the potential for significant efficiencies associated with restrictions in supply arrangements (as distinct from agreements between competitors), vertical arrangements, including resale price maintenance (**RPM**) should not be subject to per se prohibition.

3 The Federal Court's decisions in *Flight Centre*[1] and in *ANZ*[2] have created uncertainty in relation to the application of the CCA in circumstances where dual distribution models are used. These are very common in the travel industry, particularly as online booking of services and the use of online aggregators has dramatically increased in recent years. This uncertainty should be addressed to

[1] *ACCC v Flight Centre Limited* (No 2) [2013] FCA 1313

[2] *ACCC v Australian and New Zealand Banking Group Limited* [2013] FCA 1206

ensure that legitimate commercial supply arrangements are not at risk of contravention of the law and vertical agreements are not treated as cartels.

Improving access and pricing regulation in relation to airports

4 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. In Virgin Australia's experience, the current regulatory regime is not effective to guarantee these outcomes. As such, consistent with its previous submissions to the Productivity Commission, Virgin Australia proposes that a negotiate-arbitrate model be introduced in relation to aeronautical related services provided at major airports in Australia.

5 While the current declaration provisions of Part IIIA of the CCA have their limitations, Virgin Australia has, on a number of occasions, successfully used them in order to secure access and negotiate commercial terms with Sydney Airport. In particular, declaration or the threat of declaration has prompted commercial negotiations and the resolution of disputes. Until an appropriate airport-specific access and pricing regime is introduced, declaration under Part IIIA remains an important regulatory safeguard, which must be maintained.

Regulatory impediments to competition in the aviation industry:

6 State Governments have made the decision to continue to maintain certain regional routes regulated routes, often with a single operator. As a general principle, Virgin Australia supports the introduction of competition on regional routes capable of sustaining operations by two or more airlines. In cases where competition is not viable, route operators should be selected following a competitive tender process.

7 Australia's aviation regulatory regime is one of the most liberal globally, in that it provides foreign airlines with the ability to access commercial opportunities in the domestic market. Australia's aviation policy does not, however, permit foreign airlines to serve the domestic market by means of consecutive cabotage. Virgin Australia is of the view that the grant of consecutive cabotage would severely impact domestic carriers, as international carriers would have the potential to inject a significant volume of additional capacity onto domestic routes at airfares which may be lower than the average cost faced by domestic airlines in operating such services. Over the longer term, this could be expected to result in network rationalisation by local operators, whereby aircraft are redeployed onto higher-yielding routes at the expense of marginally-profitable or loss-making regional routes that deliver little overall network benefit. There is no evidence that allowing foreign airlines to operate domestic services on the basis of consecutive cabotage rights would provide durable benefits to Australian consumers or the tourism industry. Accordingly, no change to the current cabotage rules is warranted.

8 Virgin Australia recognises the importance of ensuring that capacity available under Australia's air services arrangements is sufficient to cater for future passenger and freight flows. However, all outcomes of bilateral negotiations must balance the interests of all stakeholders, including those of Australian airlines. Virgin Australia makes the following observations:

- In some cases foreign carriers are seeking increased access to operate aircraft on international routes to Australia but are unwilling to concede rights which would enable Australian airlines to offer code share services to their country.

- There is currently unutilised capacity available under almost all of Australia's existing air service agreements.
- While the bilateral system is accepted and entrenched in the rest of the world, Australian airlines are likely to be severely disadvantaged by a policy of unilateral 'open skies.'

2 Improving Competition Law

2.1 Supply arrangements should not be subject to per se prohibitions

Virgin Australia agrees with the Panel's view that, "As a general principle, the CCA should not interfere with trading conditions agreed between buyers and sellers in connection with the acquisition and supply of goods and services unless those conditions have the purpose, or would have or be likely to have the effect, of substantially lessening competition."[3]

Unlike many agreements between competitors, vertical arrangements can result in efficiencies, increased inter-brand competition, greater investment in products and distribution chains, and improvements in consumer choice and convenience. As more ways of buying and selling goods and services emerge, and multi-channel distribution models become more prevalent, businesses and consumers need more certainty about the application of competition laws to these supply relationships.

It is Virgin Australia's view that vertical arrangements should not be subject to per se prohibitions under the CCA. They are very different from horizontal agreements in their purpose, context and effect and should be treated as such. Although not terms used in the CCA, the CCA clearly distinguishes between vertical and horizontal agreements, most notably through the existence of anti-overlap provisions. Despite these distinctions, there are a number of provisions which are out of step with international standards, common business practice and the realities of the supply and distribution of goods and services in an online economy. Further, recent prosecutions by the ACCC have eroded the distinction between supply arrangements and agreements between competitors, causing uncertainty in the application of the law. Virgin Australia is concerned about the business cost and uncertainty associated with the following elements of the treatment of supply arrangements under the CCA:

- the per se prohibition against third line forcing;
- the per se prohibition against retail price maintenance;
- the unnecessary complexity associated with the operation of s 47 more generally; and
- the significant uncertainty surrounding the potential consequences of the ACCC's cases, and the Federal Court's decisions in the *Flight Centre* and *ANZ cases*.

2.2 Removal of per se prohibition against third line forcing

Virgin Australia welcomes the Panel's Draft Recommendation 27 that third line forcing should only be prohibited where it has the purpose or has or is likely to have the effect, of substantially lessening competition. As the Panel has observed, notifications to the

[3] Competition Policy Review Draft Report, September 2014 (**Draft Report**), p 45

ACCC demonstrate that third line forcing is a common business practice and very infrequently has anti-competitive effects.

In fact, in Virgin Australia's experience, third line forcing most commonly results in benefits which are valued by consumers. Virgin Australia currently has 33 active third line forcing notifications and, in 2014, has been required to lodge eight notifications. These notifications cover offers such as discounts to passengers who purchase products from travel partners and the ability to earn and redeem frequent flyer points on products such as credit cards. The need to notify such benign and ubiquitous consumer offers to the ACCC creates unnecessary legal and management costs and regulatory burdens for Virgin Australia and other businesses.

2.3 Removal of per se prohibition against RPM

Consistent with the above comments in relation to the treatment of vertical restraints, Virgin Australia is of the view that RPM should also be subject to a competition test. As the Panel has observed,

> *"Like many forms of vertical trading restrictions, in many circumstances RPM may have little effect on competition in a market. This will be the case if the product is subject to strong rivalry from competing products. In those circumstances a manufacturer or importer would be unable to specify a minimum price that is above the level determined by competition. Further, in a competitive market RPM may be beneficial to competition and consumers. The usual purpose of imposing a minimum retail price within distribution arrangements is to create a financial incentive (through the retail margin) for a retailer to invest in retailing services (whether in the form of store fit-out or retailing staff). Otherwise, retailers that invest in their stores and staff training may be vulnerable to undercutting by 'discounter' retailers that do not make that investment."*[4]

Nevertheless, Virgin Australia notes the Panel's draft recommendation that RPM remain as a per se offence, with amendments to the CCA to provide for an exception for related bodies corporate and a simplified notification process.[5]

This would result in RPM being treated under the CCA in the same way as third line forcing is currently, with the potential for similar resulting inefficiencies associated with the notification process. While it is Virgin Australia's view that the per se prohibition against RPM should be removed, Virgin Australia welcomes the Panel's view as going some way towards reducing the inefficiencies associated with the current RPM provisions.

2.4 Simplification of section 47

Virgin Australia agrees with the Panel's view that section 47 is unnecessarily complex and difficult for business to understand and apply and welcomes Draft Recommendation 28 that section 47 should be simplified and "apply to all forms of vertical conduct rather than specified types of vertical conduct."[6] In Virgin Australia's experience, the overly technical drafting of section 47 often necessitates a high degree of specialist legal advice for relatively simple supply arrangements. This creates an unnecessary cost and complexity to doing business with customers, distributors and suppliers.

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[44] Draft Report, p 234

[5] Draft Report, p 236

[6] Draft Report, pp 46; 232

2.5 Uncertainty following Federal Court's decision in *ACCC v Flight Centre*

Virgin Australia welcomes the Panel's Draft Recommendation 22 that the prohibition against cartel conduct should be simplified, including that:

> *an exemption should be included for trading restrictions that are imposed by one firm on another in connection with the supply or acquisition of goods or services (including IP licensing), recognising that such conduct will be prohibited by section 47 of the CCA (revised in accordance with Draft Recommendation 28) if it has the purpose, or has or is likely to have the effect or likely effect of substantially lessening competition.*[7]

Virgin Australia considers that this recommendation is particularly important in the light of the ACCC's decision to prosecute Flight Centre and ANZ, respectively, under price fixing provisions in relation to restrictions in distribution agreements. These prosecutions resulted in seemingly conflicting decisions by the Federal Court, both handed down in November 2013.[8]

The competition law implications of vertical supply arrangements are typically assessed against the substantial lessening of competition test (either under section 47 or section 45 of the CCA). With the exception of RPM and third line forcing, it is only agreements between competitors to which per se prohibitions, such as the cartel offences, apply.

However, the decision of Logan J in the Flight Centre case,[9] particularly when read alongside the conflicting decision of Dowsett J in the ANZ case[10], has potentially altered this position and created significant uncertainty in relation to the application of the CCA to dual-distribution models, especially where price parity or MFN clauses are involved, both of which are very common in supply arrangements.

As a travel business which utilises dual or multi distribution systems for its products, while also providing distribution services on behalf of other providers such as car hire companies and hotel booking services, Virgin Australia is especially concerned about the implications of the Flight Centre decision. Restrictions such as price parity provisions are very common in these supply agreements as they encourage and protect the investment that distributors make in distribution platforms and networks, and provide an incentive for distributors to actively promote and sell goods or services, in return for commission.

Prior to the Flight Centre case, it was relatively uncontentious that vertical restraints (conditions placed on the supply or acquisition of goods or services that restrict the way in which parties deal in those goods and services) were permitted under the CCA, provided that they did not contravene either the prohibitions against resale price maintenance[11] and third line forcing[12], constitute a misuse of market power,[13] or have the purpose or effect of substantially lessening competition.[14] In contrast, agreements between competitors (horizontal agreements) are problematic under the CCA unless they fall

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[7] Draft Report, p 41

[8] *ACCC v Flight Centre Limited (No 2)* [2013] FCA 1313; *ACCC v Australian and New Zealand Banking Group Limited* [2013] FCA 1206

[9] *ACCC v Flight Centre Limited (No 2)* [2013] FCA 1313

[10] *ACCC v Australian and New Zealand Banking Group Limited* [2013] FCA 1206

[11] In contravention of s 48

[12] In contravention of s 47(6) or 47(7)

[13] in contravention of s 46

[14] In contravention of s 45 or, as exclusive dealing, s 47

within an exception or are otherwise permitted (for example, as part of a joint venture or authorised agreement). The CCA reflects this distinction in its structure. For example, the CCA contains anti-overlap provisions that provide that agreements that constitute exclusive dealing (vertical in nature) cannot also trigger the cartel prohibitions, or that RPM (also vertical in nature) cannot also be price fixing (horizontal, cartel conduct).[15] This structure mirrors the economic and commercial reality that agreements between suppliers and customers are in a different category to agreements between competitors.

This distinction has always been more difficult to navigate where there are dual distribution models in use and the question of whether a customer or supplier is also a competitor arises. However, it has generally been accepted that, in circumstances where there are dual distribution models, downstream suppliers are not competitors where the downstream supplier is acting as an agent for the upstream supplier (which is a question of fact).

Where no agency arrangement exists, businesses have typically structured non-price restraints on supply to fall within exclusive dealing under section 47 of the CCA and take the benefit of the anti-overlap provisions, provided there is no substantial lessening of competition.

The Flight Centre case is inconsistent with this position and has created significant uncertainty for businesses which use or are involved in dual-distribution models and for those advising them. In particular, the Flight Centre case deviates from the analysis above because it takes as a starting position the existence of a separate market for the supply of distribution or booking services (as distinct from air travel or car hire), in which both principal and agent compete for a margin or commission. Virgin Australia considers that this analysis does not reflect the factual realities of these markets, nor does it properly sit within the structure of the CCA. For example, if the "commission" is relevantly a price in the market, then any agreement between principal and agent on the level of commission would constitute price fixing. This cannot be the case. Further, in Virgin Australia's view, the argument and finding that a commission or margin at one level of the market (which represents the distributor's fee for distributing the producer's goods or services), is the price for a booking service downstream, is not commercially realistic or legally sound. It also ignores the distinction between horizontal and vertical arrangements in the CCA, conflating RPM and the cartel offence of price fixing, as well as undermining the operation of the anti-overlap provisions.

Virgin Australia understands that both the Flight Centre and ANZ cases are still subject to the appeals process. However, if the issues are not resolved in any appeal, then there will remain significant uncertainty for businesses, particularly those which utilise dual distribution models. The ACCC's arguments and the Court's decision in *Flight Centre* has potentially far reaching, and sometimes absurd, consequences if the reasoning is applied in the same way. If applied broadly, it could put into question the lawful and efficient supply and distribution arrangements of thousands of businesses – for example, are price parity clauses between a producer and its distributor now to be considered price fixing?

This is not to say that the conduct of Flight Centre ought not to have been prosecuted or that it did not offend against the CCA. It is simply that the decision to prosecute under price fixing provisions, generally understood to apply to horizontal conduct, has the potential to have unintended consequences. If not resolved at appeal, Virgin Australia is of the view that there may be the need for a legislative response, or a policy statement, consistent with the Panel's recommendation that the cartel provisions should not apply to

[15] CCA, s 45(6); s 44ZZRS; s 44ZZRR

supply arrangements and the principle that vertical arrangements should not be per se illegal.

3 Improving access and pricing regulation of airports

3.1 Airports remain as key bottle-neck facilities not subject to an industry-specific access regime

The Panel has noted that:

> *"Part IIIA of the CCA was originally enacted to provide a common framework for access to infrastructure within each of those industries. However, it soon became clear that each industry had distinct physical, technical and economic characteristics and that it was preferable to address access issues on an industry-by-industry basis. Distinct access regimes have subsequently emerged."*[16]

While it is the case that most of the infrastructure facilities identified by Hilmer as bottlenecks are now regulated by industry-specific regulation, airports are a clear exception. Currently, if commercial negotiations are unsuccessful, Part IIIA is the only avenue available to airlines seeking access to airport facilities. As the Panel has noted, since Part IIIA of the CCA was enacted in 1995, three of the five services to have been successfully declared have been major airports.[17] This reflects the absence of an appropriate alternative regulatory scheme, the importance of access to this infrastructure to ensure competition in the aviation and associated markets as well as the ability of major airports to engage in monopoly pricing or to restrict access, except where there is a clear commercial incentive otherwise.

The Panel has invited submissions on the infrastructure facilities which may be regulated under Part IIIA in the future and, whether there are categories of facility to which the scope of Part IIIA should be confined. Virgin Australia considers that, in the absence of a comprehensive airport-specific access and pricing regime, it is crucial that Part IIIA's declaration process continue to apply to airports.

In Virgin Australia's experience, Part IIIA is a second-best option for ensuring access. Its application can be uncertain and the declaration process has, at times, proven costly and time consuming. However, both the threat of declaration, and the availability of arbitration once a facility has been declared, have proven invaluable in securing access.

As new entrants and as market challengers, Virgin Australia and its subsidiary Tigerair Australia have both needed to rely on Part IIIA to facilitate commercial outcomes when dealing with major airports. In some cases Virgin Australia has been able to quickly achieve effective commercial negotiations following the making of an application for declaration; in others arbitration has only resulted after protracted legal battles. For these reasons, Virgin Australia advocates the adoption of a negotiate-arbitrate access model for airports. Virgin Australia's experiences with Part IIIA and its preferred access model are set out below. However, until and unless such a model is implemented, declaration under Part IIIA remains an important safeguard.

[16] Draft Report, p 265

[17] Draft Report, p 266

3.2 Limitations of the current regulatory regime

Virgin Australia considers that:

- airlines are limited in their ability to 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 in line with increased costs.

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.

Further, as discussed below, the current price monitoring regime and the declaration provisions of Part IIIA of the CCA have their limitations.

Virgin Australia's experience with Part IIIA of the CCA demonstrates that:

- for the most part, 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.

Virgin Australia considers that 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 the airports' substantial market power and the inelastic demand for services at most airports.

Virgin Australia 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 Australia put to the Productivity Commission in submissions in 2006 and in 2011. [18]

[18] See: *Productivity Commission Inquiry: Economic regulation of airport services: Submission by Virgin Blue Airlines*, 18 April 2011, http://www.pc.gov.au/__data/assets/pdf_file/0016/108322/sub054.pdf; Price regulation of airport services: submission to the productivity commission from Virgin Blue Airlines, 21 July 20016, http://www.pc.gov.au/__data/assets/pdf_file/0016/108322/sub054.pdf

3.3 How effective is the current economic regulatory regime?

Currently, airport regulation consists of a combination of price monitoring by the ACCC and the availability of declaration under Part IIIA of the CCA.

(a) Price Monitoring

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.

Virgin Australia considers that price monitoring would have a useful function in a negotiate-arbitrate model as transparency about airports' costs would greatly assist commercial negotiations.

(b) Declaration under Part IIIA

As the Panel is aware, Part IIIA of the CCA consists 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 specified criteria set out in Part IIIA of the CCA (section 44F).

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 (section 44F). The NCC must make its recommendation to the relevant Minister on the basis of the criteria set out in section 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.

(c) Application of Part IIIA in relation to the aviation industry

There have been two instances in which services provided by Sydney Airport have been successfully declared under Part IIIA.

First, in *Sydney International Airport [2000] ACompT 1* (1 March 2000), 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 Australia 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.

More recently, in 2014, following a period of unsuccessful commercial negotiation in relation to access to the common user facilities at Sydney Airport, Tigerair Australia made an application to the NCC for the declaration of services at Sydney Airport. The threat of arbitration worked almost immediately to encourage Sydney Airport to engage in negotiations. A commercial agreement was reached and the application for declaration was withdrawn in a short time frame and without incurring excessive costs.

(d) Limitations of relying on the declaration provisions of Part IIIA of the CCA

The limitations of relying on declaration under Part IIIA of the CCA to constrain the market power of major airports stem from three 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.

Each is discussed in more 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.

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,[19] 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 was 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 had to provide lengthy submissions to the NCC (including expert economic reports).

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19 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.

(e) 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.

3.4 Virgin Australia's preferred model of airport access regulation

Virgin Australia has consistently stated that its preference is to commercialiy 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, 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 Australia 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 Australia'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.

3.5 Key features of Virgin Australia's proposed model

Consistent with its 2006 and 2011 submissions to the Productivity Commission, Virgin Australia 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.

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

Virgin Australia 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.

The adoption of an airport-specific negotiate-arbitrate model, such as that proposed by Virgin Australia, would remove the need for the continued application of declaration under Part IIIA to airports. However, until such a model is adopted, Part IIIA plays an important role in facilitating access to airport infrastructure.

4 Regulatory Impediments to Competition in aviation industry

4.1 The effect of aviation policy and regulation

Australian aviation policy has remained relatively stable over the last decade, reflecting the bipartisan approach adopted by successive Commonwealth governments. This has provided industry with a measure of certainty to guide commercial planning and investment decisions, and it is widely acknowledged that these policy settings have generated significant benefits for Australian consumers, tourism and trade. Virgin Australia is of the view that the Coalition's Policy for Aviation articulates a contemporary and forward-looking position on key issues facing Australia's aviation sector, which is consistent with and supports its Policy for Tourism.

Aviation is one of the most heavily regulated industries in the world. While much of this regulation is necessary to safeguard the integrity of air transport operations, such as in the areas of safety and security, there is significant scope to reduce, streamline and enhance the regulatory and compliance requirements for the industry in a number of areas. Unnecessary regulatory burdens are compounding the financial pressures faced by airlines, with the result that operators are finding it increasingly difficult to keep revenues ahead of costs. With the global industry's average net margin at just 2.4%, or

less than $6 per passenger,[20] the financial performance of airlines does not reflect the social or economic value that air services deliver to consumers, communities, exporters and businesses. In this regard, Virgin Australia welcomes the Commonwealth Government's efforts to reduce the regulation across the economy, including within the aviation sector, under its red tape reduction programme. Earlier this year, Virgin Australia lodged a submission to this review, highlighting opportunities to improve a number of aspects of regulation in order to deliver increased efficiencies and reduced costs for the aviation sector, with consequential benefits for the tourism industry.

Comments are provided below on those aspects of aviation policy and regulation considered by the Panel which Virgin Australia considers directly impact the competitiveness, productivity and efficiency of air services to, from and within Australia.

4.2 Australia's bilateral air services agreements

Virgin Australia supports the Commonwealth Government's policy objective of promoting aviation liberalisation, and the role of this policy in facilitating growth in the tourism industry and Australia's economic development more broadly. In particular, Virgin Australia recognises the importance of ensuring that capacity available under Australia's air services arrangements is sufficient to cater for future passenger and freight flows. Virgin Australia would, however, highlight that the outcomes reached in bilateral negotiations with countries in settling new or expanded air services entitlements, must balance the interests of all stakeholders, including those of Australian airlines. It is important to note in this regard that requests for capacity by airlines are not confused with actual economic demand for air services.

As noted above, the competitiveness of Australia's tourism sector depends on the existence of strong local operators, particularly for transporting international visitors to regional areas, where 45 cents of every tourism dollar is spent[21]. The sustainability of air services provided by Australian airlines depends in part on the ability to access new sources of revenue through an increased network footprint. Australian airlines are increasingly choosing to pursue cost-effective network expansion opportunities by offering code share services on flights operated by other airlines, in preference to own-aircraft operations. It is therefore imperative that requisite code share rights are secured for Australian airlines as part of any bilateral air services negotiations. With many countries, code share rights are of much greater value to Australian carriers than an expanded capacity entitlement for own-operated services.

In some cases, foreign carriers are seeking increased access to the Australian market for own-aircraft operations, while at the same time being unwilling to concede rights which would enable Australian airlines to offer code share services to their country. Without these rights, the competitiveness of Australian carriers will be eroded over time – not only in the international context, but also domestically, as the viability of international and domestic networks is inextricably linked. Weak or uncompetitive Australian airlines will be far less able to play a meaningful role in supporting the development of the tourism industry.

From time to time, some segments of the tourism sector have called on the Australian Government to conclude unilateral 'open skies' air services arrangements, providing unlimited rights for foreign airlines to serve Australia. This view is based on the

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[20] Speech by International Air Transportation Association Director General Tony Tyler, Doha, 2 June 2014.

[21] Tourism 2020, Tourism Australia's journey 2010 to 2013, October 2013 http://www.tourism.australia.com/documents/Statistics/TACP8132_2020_Update_2013-SP.pdf

expectation that such arrangements will result in more flights to Australia. This is a short-sighted perspective which fails to recognise the substantial contribution that Australian carriers make to the nation's tourism industry. On this point, in its 1998 inquiry into international air services, the Productivity Commission concluded that, "...as long as the bilateral system is accepted and entrenched in the rest of the world, Australian airlines are likely to be severely disadvantaged by a policy of unilateral 'open skies'"[22]. This view appears to be accepted by the Panel.[23]

Furthermore, it is worth noting that there is capacity currently available under almost all of Australia's air services agreements to accommodate the operation of additional flights by both Australian airlines and airlines of foreign countries.

Drawing upon Virgin Australia's experience as a member of the Australian Government delegation at many bilateral air services negotiations, it is our view that, in general, the Department of Infrastructure and Regional Development (the Department) effectively balances the interests of all stakeholders and extracts the maximum value from the negotiating leverage it holds. In many cases, this leverage is limited, given Australia's geographic position as a non-hub, end-of-the-line destination with a relatively small population. This is a challenging task, which in Virgin Australia's opinion has been managed well by the Department to date. Based on past performance and the significant complexities and unique features inherent in the bilateral air services framework, Virgin Australia supports responsibility for air services negotiations remaining with the Department.

4.3 Cabotage

Virgin Australia notes the Panel's View that "restrictions on cabotage for shipping and aviation should be removed unless they can be shown to produce outcomes that are in the public interest and those outcomes can only be achieved by restricting competition."[24] It also notes that the Panel did not receive any submissions arguing for the removal of restrictions on cabotage for aviation, "but considers there is likely to be considerable benefits flowing from the removal of air cabotage restrictions on remote and poorly serviced domestic routes."[25]

In this context, Australia's aviation regulatory regime is one of the most liberal globally, in that it provides foreign airlines with the ability to access commercial opportunities in the domestic market. This includes "investment cabotage", which enables foreign airlines or entities to hold 100% of the equity in an Australian domestic airline, subject to national interest tests. Both Virgin Blue and Tiger Airways were established under this policy, as airlines wholly owned by foreign interests. These operators brought increased competition and innovation to the domestic market, providing consumers with more services, greater choice and lower airfares.

Australia's aviation policy does not, however, permit foreign airlines to serve the domestic market by means of consecutive cabotage. If these rights were granted, foreign carriers would be likely seek to operate on key domestic routes between major gateways, alongside Australian airlines, earning marginal revenue while incurring marginal cost from an aircraft that would otherwise have remained idle in the intervening time period between international services. Domestic carriers would be severely impacted as a

[22] International Air Services Inquiry Report, Productivity Commission, Report No. 2, 11 September 1998 at 220.

[23] Draft Report, p 115

[24] Draft Report, p 133

[25] Draft Report p 132

result, with foreign carriers potentially injecting a significant volume of additional capacity onto these routes at airfares which may be lower than the average cost faced by domestic airlines in operating such services. Over the longer term, this could be expected to result in network rationalisation by local operators, whereby aircraft are redeployed onto higher-yielding routes at the expense of marginally-profitable or loss-making regional routes that deliver little overall network benefit. Allowing foreign airlines to operate domestic services on the basis of consecutive cabotage rights would fail to give adequate recognition to the essential role that domestic airlines play in supporting Australia's tourism industry.

It is also important to note that under most of Australia's air services arrangements, foreign airlines have the ability to access multiple points in Australia, either with their own aircraft or under code share arrangements with domestic carriers. Under the Department's "Regional Package", foreign carriers are offered unrestricted access to all points in Australia other than Brisbane, Sydney, Melbourne and Perth on a unilateral basis during air services negotiations. In addition, most of Australia's bilateral air services agreements extend own stopover rights to foreign carriers, enabling them to carry their international passengers to multiple points in Australia with the same aircraft. Opportunities for foreign airlines to code share on Australian carriers' extensive domestic networks are also commonplace under Australia's air services arrangements.

Australia's investment cabotage policy allows foreign entities access to the domestic market, but entails a necessary commitment to the establishment of a long-term presence, generating employment and supporting economic development. In contrast, consecutive cabotage allows foreign airlines to take opportunistic advantage of the domestic market, at the expense of the viability and stability of the local industry, with little benefit for the broader economy. The investment cabotage policy also promotes competitive discipline among domestic airlines, through the omnipresent threat of new market entrants.

Overall, the benefits to consumers, the tourism industry and the broader economy of permitting foreign airlines to serve the Australian domestic market through consecutive cabotage would be limited. This was confirmed in the conclusions of the Productivity Commission in its review of international air services, where it stated that, "...it is unlikely that such services would lead to substantial efficiency gains in Australian resource allocation, as the Australian airline industry is relatively efficient and internationally competitive."[26] Virgin Australia would argue that current levels of competition in all segments of the domestic market are substantially greater than was the case in 1998 when the aforementioned review was undertaken, which suggests that granting consecutive cabotage rights is unwarranted and would be highly unlikely to yield any tangible benefits for Australia's tourism industry.

4.4 Regulated regional routes

High-yielding international tourists make a valuable contribution to the economic development of Australia's regions. Tourism development in these areas depends on access to regular, affordable, safe and reliable air services. Some state governments seek to impose regulatory restrictions on certain intrastate routes for public policy reasons, where access to such air services cannot be assured. in many cases this involves the creation or maintenance of single-operator routes. This has implications for tourism growth in these regions.

[26] International Air Services Inquiry Report, Productivity Commission, Report No. 2, 11 September 1998 at 227.

As a general principle, Virgin Australia supports the introduction of competition on those routes capable of sustaining operations by two or more airlines. Whether a route is suitable for deregulation will depend on a wide range of factors, such as passenger volumes and growth, local population levels and growth and current and planned significant economic projects or undertakings in the region. Decisions regarding the potential deregulation of any route must be assessed on a case-by-case basis, to ensure that adequate regard is given to the specific characteristics of the particular route.

In Western Australia, regulated markets such as Perth-Albany and Perth-Esperance are unlikely to be suitable for deregulation, with passenger volumes below 60,000 and 45,000 respectively. Opening these routes to competition poses a significant risk of market failure, with consequential negative implications for regional communities and all sectors of their economies, including tourism.

In sharp contrast, the Queensland Government has determined that the Brisbane-Roma route will remain regulated and free from competition until at least 2020, notwithstanding that passenger numbers grew from just under 40,000 in 2008-09 to over 240,000 in 2013-14. This decision cannot be justified from either an economic or public policy perspective. The costs of restricting competition on this route will be borne by passengers, in the form of higher airfares and fewer travelling options, as well as the economy more broadly, including by limiting opportunities for growth in tourism.

In considering the need to restrict competition on intrastate routes, state governments should be encouraged to take into account the potential impacts of such decisions on the tourism industry, which is a vital economic sector within many regional communities. State governments must also recognise that if they wish to pursue defined objectives in relation to the adequacy of regional air services, eg frequency and pricing, the supporting regulatory framework cannot be based on a premise that private airline businesses will be prepared to operate services without generating a commercial return.

Virgin Australia agrees with the Panel's view that "Governments should only create exclusive rights for regional services where it is clear that the air route will only support a single operator. Where exclusive rights are created they should be subject to competitive tender."[27] Further, Virgin Australia considers that better and more competitive outcomes would be achieved through a competitive tender process than under a price regulation system, as proposed by the Panel in the alternative.

[27] Draft Report, p 116