Conservative estimate of net benefits of the reforms

RESPONSE TO HOUSTON KEMP'S CRITIQUE OF FRONTIER ECONOMICS' ECONOMIC EVALUATION REPORT

Assumptions used in the analysis

In an attachment to the AAA's supplementary submission to the PC's Issues Paper, Houston Kemp provided a critique of some of the assumptions underpinning Frontier's evaluation of A4ANZ's proposed regulatory remedy. Namely:

- the extent of cost pass-through;
- the presumed effectiveness of the proposed regulatory remedy;
- the description of transfers from airports to airlines/customers as 'benefits'; and
- the overlooking of the potential for additional costs because of the reform.

We acknowledged that there are uncertainties associated with these assumptions. Ideally this would be managed by subjecting the analysis to a full sensitivity analysis, however, this was not possible in the time allowed for submissions.

Instead, to manage this issue the analysis was separated into two components.

First, we explored whether the reforms would be **cost effective**— The uncertainty in this assessment was largely limited to the impact of the reforms on the likelihood parties might seek arbitration.

Second, we considered whether the reforms might be likely deliver **additional benefits**. There was greater uncertainty around the assumptions used in this analysis and so these estimates were provided to given some indication of the potential scale or significance of the benefits that have in the past been commonly overlooked.

In box 1 we provide more detail behind the rationale for the cost pass through assumption adopted in our analysis.

Box 1: The cost-pass through assumption

We agree with Houston Kemp that there is no economic theory that supports an a priori assumption about the extent of cost pass-through. We note in our economic evaluation report that the exact amount of pass through will depend on the nature of demand and the competitiveness of the air travel on any route.

Whilst assumptions about cost pass through are important when formally assessing pricing outcomes for the purpose of a market power assessment this is less critical when used as an input into the connectivity analysis.

By way of example, if we assume there is zero pass through of airport charges to airfares this would still impact on an airlines' costs on any route i.e. a rise in airport charges will increase the fixed costs of airlines, making routes less viable. Similarly, if we assume 100% pass through of airport charges to airfares the rise in airport charges will reduce demand, thereby making the route less viable from an airlines perspective.

Given the primary purpose of this analysis was to explore the impact of airport charges on connectivity and route viability, any fall in airport charges (as a result of changes to the regulatory regime) could be viewed as beneficial to passengers, if it drives new connectivity. Irrespective of whether this comes through lower fares or through lowering the fixed costs of airlines. Therefore, to simplify the analysis we assumed 100% pass through.

This pass-through assumption will affect the passenger demand response. However, it is worth noting that we assumed a 1.9% increase in passenger demand in response to the anticipated fall in airport charges. This is only marginally above the increased traffic forecast by InterVISTAS, the AAA's advisor, who estimated there could be a 1.2% increase in total demand in response to a 10% decrease in airport charges[1].

Source: Frontier Economics

Conservative estimate of the benefit of the reforms

Many of the other uncertainties raised by Houston Kemp are already directly acknowledged in our report. However, on the whole they do not alter the conclusions of the analysis. For the purpose of demonstrating the significance of these matters we have completed a simplified, sensitivity analysis based on adopting conservative estimates for the key costs and benefits described in the report and discounting these to account for uncertainty.

For the purposes of this simplified assessment we have assumed the following:

- Implementation costs for the ACCC and industry are as described in the evaluation report.
- The reduced administration costs associated with more timely negotiations are as described in the evaluation report.
- A further $23 million in administrative cost is incurred associated with a significant increase in arbitrations — While we do not consider that there is sufficient evidence to suggest that access to an FOA regime will encourage parties to seek arbitration as a "default. For the purposes of this simplified sensitivity analysis we have allowed for additional administrative costs for this. This figure would equate to over 23 FOA arbitrations in the next 15 years assuming each arbitration costs airlines, airports and the arbitrator, $1 million in total.
- For this simplified sensitivity assessment, we have discounted all other direct benefits by 50%. Namely the dead weight loss and travel time savings estimates. This is to account for the uncertainty around the effectiveness of the regulatory remedy and the elasticity of demand.
- The wider benefits associated with increases in trade and FDI, driven by improvements in connectivity, have not been included.

The table below summarises the values of the revised costs and benefits under these conservative input assumptions and the outcomes that result. As demonstrated in the table below the regulatory reforms would still deliver $445 million in net benefits with a benefit to cost ratio of 14:1.

[1] InterVISTAS, (2018), *The Impact of Airport Charges on Airfares*, prepared for the Australian Airports Association, p59 (source: https://www.pc.gov.au/__data/assets/pdf_file/0013/231430/sub050-airports-attachment3.pdf)

Table 1: Summary of costs and benefits

Costs and Benefits	NPV of Costs[2]	
Cost to the ACCC of implementing minor amendments to its monitoring approach	$2 million	As per report
Cost to airports from the introduction of an information transparency and disclosure regime	$9 million	As per report
Increase in costs associated with arbitrations	$23m	Additional cost item
Total Cost	**34 million**	
Improved timeliness of negotiation	34 million	As per report
Travel time saving (50%)	410 million	Benefit discounted by 50%
Deadweight loss (50%)	36 million	Benefit discounted by 50%
Total Benefit	**479 million**	
Net Benefit	**445 million**	
Benefit to Cost Ratio	**14:1**	

Source: Frontier Economics

2 Assuming a 15 year evaluation period, and real discount rate of 7%.

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