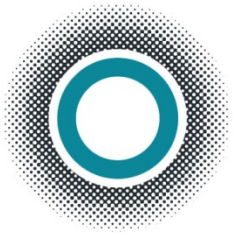
AAA Attachment 1



HOUSTONKEMP
Economists

Assessing market power in aeronautical services: supplementary report

A report for the Australian Airports Association

15 March 2019

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Disclaimer

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Executive Summary

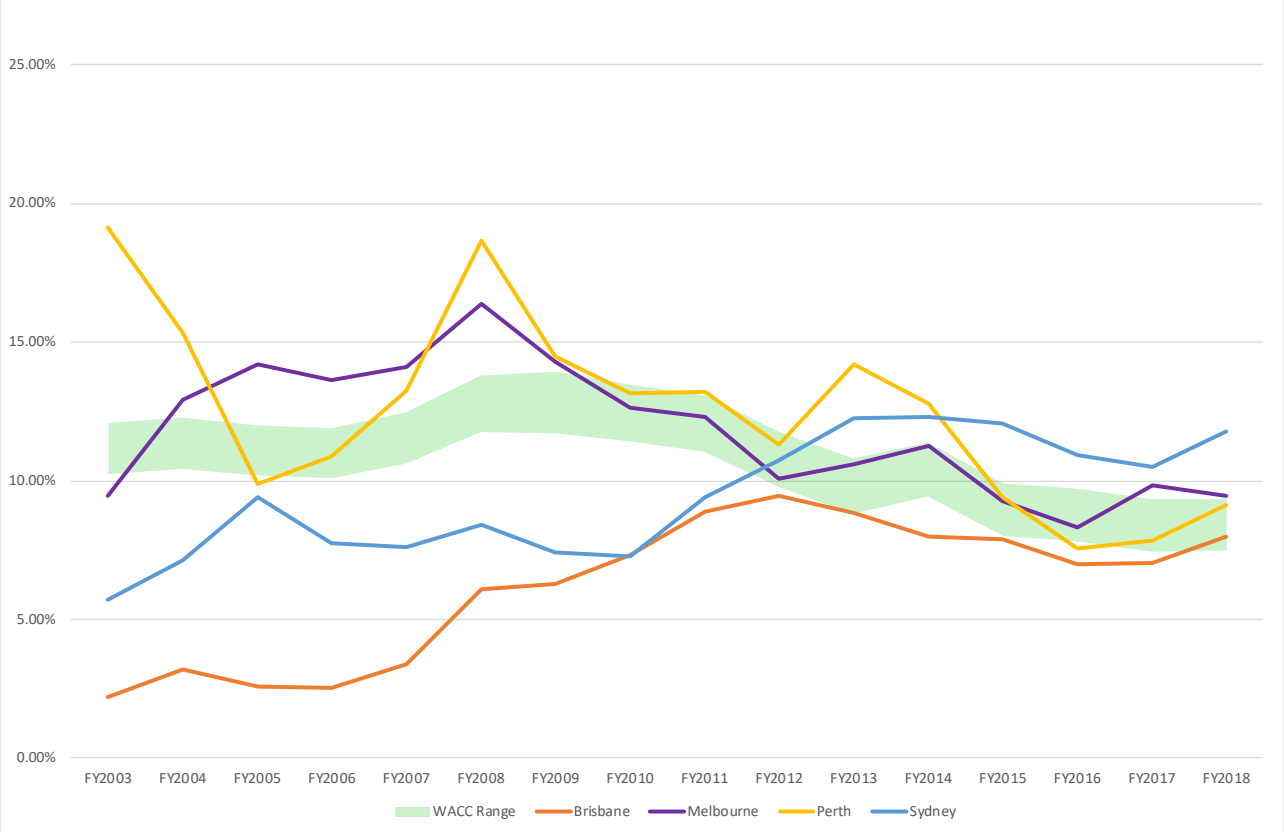
This report supplements our earlier report[1] examining the extent to which the pricing of aeronautical services by the four airports – Sydney, Melbourne, Brisbane and Perth (the airports) – the subject of the airports price monitoring regime administered by the Australian Competition and Consumer Commission (ACCC) can be said to reflect the exercise of any market power. It should be read in conjunction with our earlier report.

The purpose of this supplementary report is:

- to incorporate data in relation to returns on aeronautical assets that is now available for the 2017/18 year; and
- to correct a calculation error identified in our earlier report – as recently identified by Frontier Economics[2] – the consequence of which was to overstate the upper bound of our estimated reasonable range for the return on aeronautical assets.

Figure 1 below shows the return on aeronautical assets for each airport in each year during the period 2002/03 to 2017/18, along with our corrected, year-by-year upper bound values for the estimated range for the weighted average cost of capital (WACC) for a benchmark Australian airport. The lower bound values for the WACC remain unchanged.

Figure 1: Returns on aeronautical assets for price monitored airport and WACC range



[1] HoustonKemp, *Assessment market power in aeronautical services*, A report for the Australian Airports Association, 5 September 2019.

[2] Frontier Economics, *Market power and the profitability of Australian airports – response*, Prepared for A4ANZ, 11 December 2018, footnote 5.

The narrowing of the range for the estimated WACC applicable to aeronautical services does not alter the central conclusion of our earlier report, ie, that none of the four airports can be said to have set prices or achieved levels of profit that reflect the exercise of any market power.

However, the narrower range for the estimated WACC means that, for two of the four airports (being Melbourne and Perth), the airport-specific commentary accompanying our earlier report requires modest amendment. In particular, the commentary for each airport should that appeared in section four of our earlier report should now read as follows:

- for Brisbane airport, the return on aeronautical assets has been consistently at or below the lower bound for the benchmark WACC throughout the period, with its average return being 360 basis points below, but that since 2011/12 Brisbane airport has achieved a return on aeronautical assets close to the bottom of the range of our estimated reasonable WACC;
- Melbourne airport's return on aeronautical assets has, on average, been close to our estimated upper bound for the benchmark WACC and, since 2009/10, has generally been within the range of reasonable estimates of the WACC for a benchmark provider of aeronautical services; for several years in the earlier part of the period, Melbourne airport exceeded the upper bound of the WACC range by around 1.5 per cent, which coincides with a period – most markedly, in 2003/04 and 2004/05 – in which it experienced significant passenger growth;
- for Perth airport, the return on aeronautical assets has, on average, been slightly above the upper bound of the estimate of the WACC; however, since 2014/15, aeronautical returns have been at or below the lower bound of our estimated range for the WACC; and
- Sydney airport's return on aeronautical assets has been below our estimated lower bound for the benchmark WACC for most of the assessment period, but has risen above our upper bound assessment since 2013/14; over the entire assessment period, Sydney airport's average return on aeronautical services has been 35 basis points below the average of our estimated lower bound for the benchmark WACC.

Overall, as before, these results strongly support a conclusion that none of the four airports can be said to have set prices or achieved levels of profit that reflect the exercise of any market power. Further, although not the focus of our report, the Productivity Commission's 2011 findings in relation to rates of productivity growth and trends in service quality achieved by the airports are also consistent with the conclusion that there has been no exercise of market power in the provision of aeronautical services.

1. Introduction

This report supplements our earlier report[3] examining the extent to which the pricing of aeronautical services by the four airports – Sydney, Melbourne, Brisbane and Perth (the airports) – the subject of the airports price monitoring regime administered by the Australian Competition and Consumer Commission (ACCC) can be said to reflect the exercise of any market power. It should be read in conjunction with our earlier report.

The purpose of this supplementary report is: :

- to incorporate data in relation to returns on aeronautical assets that is now available for the 2017/18 year; and
- to correct a calculation error identified in our earlier report – as recently identified by Frontier Economics[4] – the consequence of which was to overstate the upper bound of our estimated reasonable range for the return on aeronautical assets.

The remainder of this report sets out the revised results of our empirical analysis of the price cost relationship for aeronautical services, and so the economic returns to airports, over the now 16-year period since the price monitoring regime has been in place. This updates and amends the analysis that was presented in section 4 of our earlier report. Sections 2 and 3 of our earlier report continue to stand, as before.

[3] HoustonKemp, *Assessment market power in aeronautical services*, A report for the Australian Airports Association, 5 September 2019

[4] Frontier Economics, *Market power and the profitability of Australian airports – response*, Prepared for A4ANZ, 11 December 2018, footnote 5.

2. Profitability assessment of the four airports

In this section we report the results of our empirical assessment of market power by reference to the framework we establish in our original report, ie, an empirical analysis of the price cost relationship for aeronautical services, and so the economic returns to airports, over the now 16-year period since the price monitoring regime has been in place.

2.1 Methodology

The essence of our profitability analysis is the derivation of an annual comparison of:

- the rate of earnings before interest and tax (EBIT) as a percentage of the aeronautical asset base for each of the four airports, in each year since 2003 through to 2018, using data disclosed by the ACCC in its annual airport price monitoring reports;[5] and
- an estimated range for the pre-tax nominal,[6] weighted average cost of capital (WACC) for a benchmark Australian airport, derived using readily available upper and lower bounds for each WACC parameter, as drawn from either airport or other infrastructure service provider decisions made by the ACCC.

The purpose of the estimated WACC that we adopt for this comparison is not to provide an opinion on the likely cost of capital for any particular airport, but rather to identify the range of estimates that is reasonably able to be drawn from material readily available in the context of regulatory decisions on infrastructure pricing.

In the following four sections, we present the results of our analysis for Brisbane, Melbourne, Perth and Sydney airports, respectively.

[5] In undertaking this analysis, each of the four airports was provided with an opportunity to review and correct the revenue and asset data reported by the ACCC in its annual airport price monitoring reports. Any corrections made to the ACCC-reported figures are indicated in the relevant section for each airport.

[6] The pre-tax nominal form of the WACC is that which corresponds to the earnings before interest and tax measure of airport profitability, as published by the ACCC.

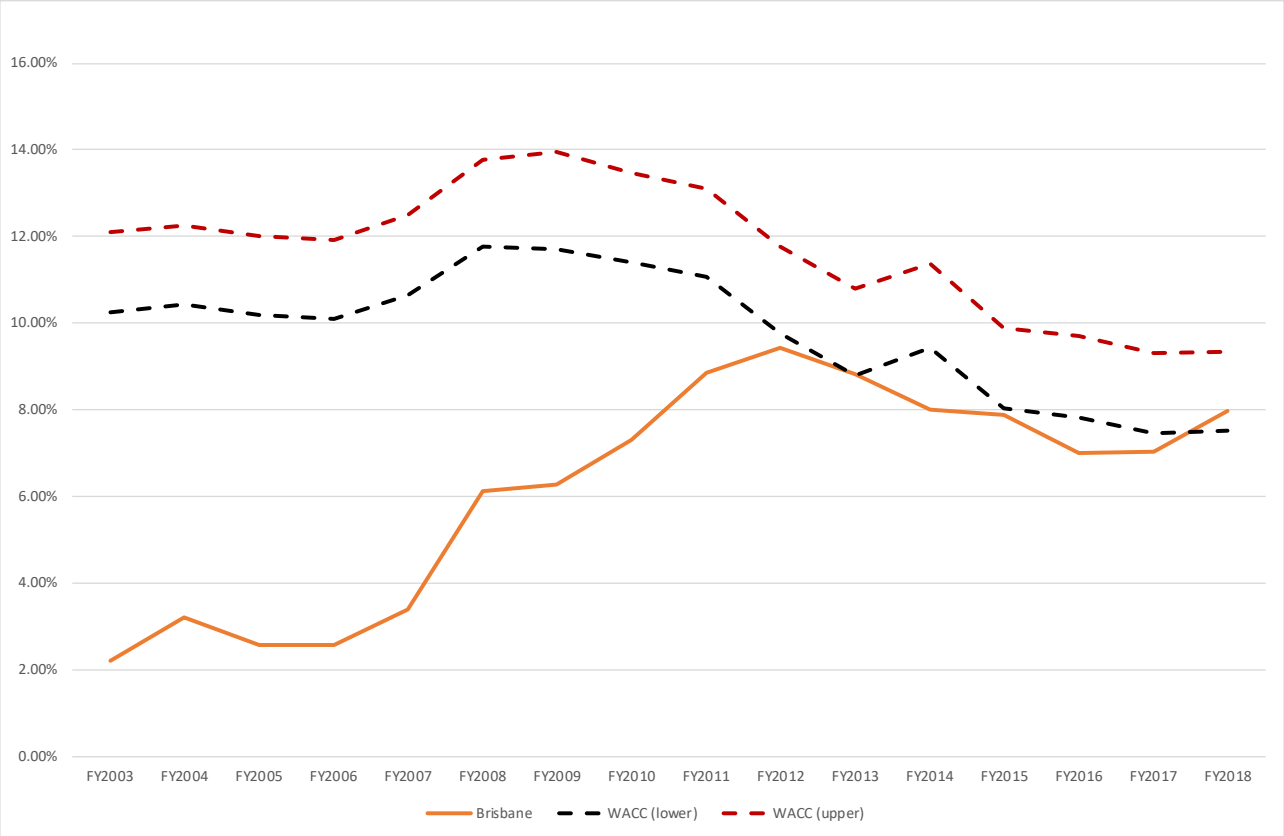
2.2 Brisbane airport

Figure 2 shows the return on aeronautical assets at Brisbane airport in each year during the period 2002/03 to 2017/18.

The reported return on aeronautical assets at Brisbane airport has been consistently at or below the WACC for a benchmark provider of aeronautical services throughout the period, although since 2011/12 Brisbane airport has achieved a return on aeronautical assets close to the bottom of the range of our estimated reasonable WACC.

Over the assessment period, Brisbane airport's average return on aeronautical assets has been 389 basis points below our estimate of the reasonable lower bound for the WACC.

Figure 2: Returns on aeronautical assets for Brisbane Airport[7]



[7] The ACCC's 2004/05 Airport pricing monitoring and financial report states that Brisbane airport's aeronautical revenue for 2003/04 was $71.557 million. Brisbane airport has indicated that aeronautical revenue for 2003/04 was $74.862 million, as reported in the 2003/04 Airport pricing monitoring and financial report. We note that this change has no material impact on our analysis of aeronautical returns at Brisbane airport.

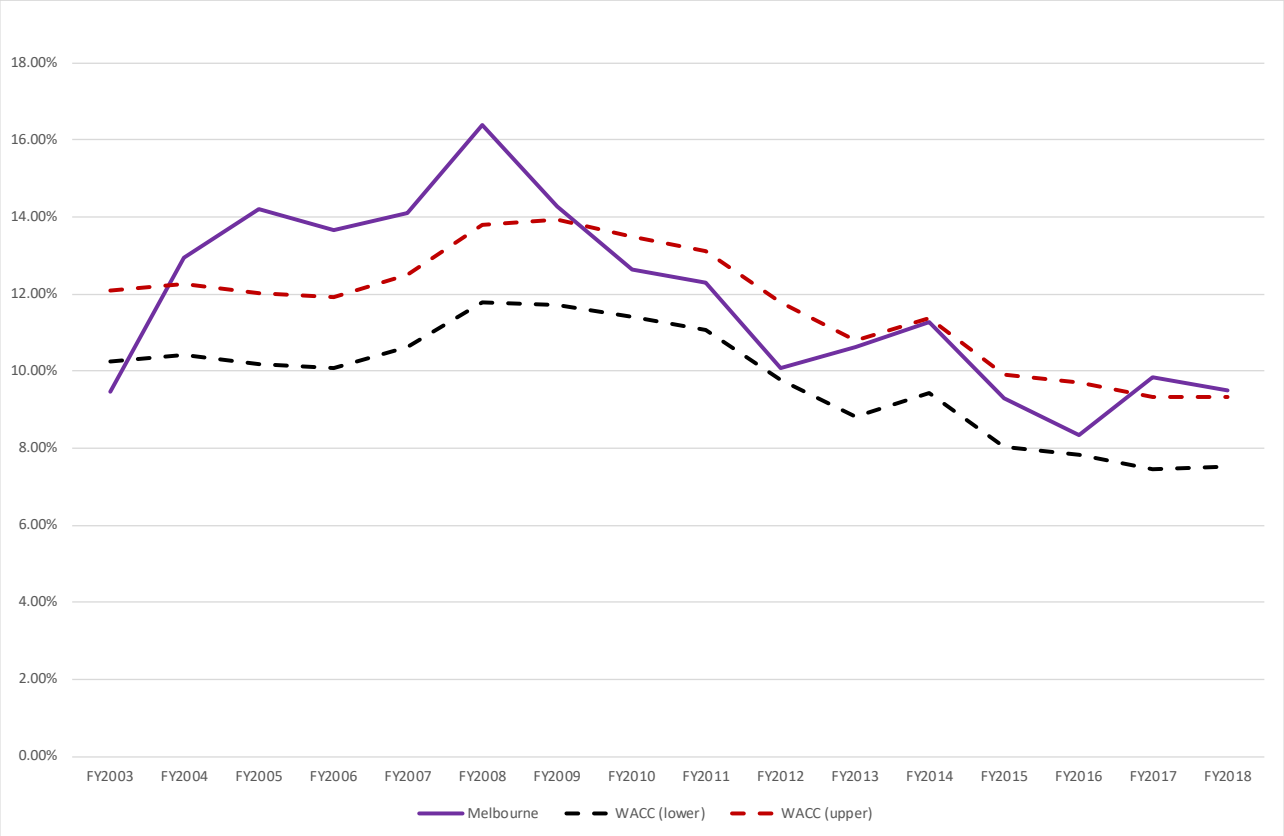
2.3 Melbourne Airport

Figure 3 shows the return on aeronautical assets at Melbourne airport in each year during the period 2002/03 to 2017/18.

The average of Melbourne airport's reported returns is in line with the corresponding upper bound of our estimated upper bound of the benchmark WACC.[8] Since 2009/10, Melbourne airport's reported return on aeronautical assets has generally been within the range of the WACC for a benchmark provide of aeronautical services.

Over the assessment period Melbourne airport's return on aeronautical assets exceeded the upper bound of the WACC range for aeronautical assets from 2003/04 through until 2008/09. We note that this period coincided with Melbourne airport experiencing significant passenger growth, with total passenger throughput increasing by 13.2 per cent and 8.4 per cent increase in 2003/04 and 2004/05, respectively.[9]

Figure 3: Returns on aeronautical assets for Melbourne Airport[10]



[8] Melbourne airport has an average return on assets of 11.79 percent, which is 10 basis points above the 16 year average of our estimated upper bound benchmark WACC.

[9] ACCC, Airport price monitoring and financial reporting 2005-06, February 2007, page 224.

[10] The ACCC's 2015/16 Airport pricing monitoring and financial report incorrectly reports $83.83 million in abnormal aeronautical revenue for associated with the change in the fair value of investment property. Melbourne airport has indicated that the change in the fair value of investment property should be allocated to non-aeronautical revenues.

2.4 Perth Airport

Figure 4 shows the return on aeronautical assets at Perth airport in each year during the period 2002/03 to 2017/18.

The reported return on aeronautical assets at Perth airport has, since 2014/15, been below or within our estimated range for the WACC.

Over the assessment period Perth airport's average return on aeronautical services is 12.52 per cent, which is modestly above the upper bound of the estimate of the WACC. The principal driver of this outcome is its higher returns in the first year of the assessment period and the spike in returns in 2007/08.

Figure 4: Returns on aeronautical assets for Perth Airport

2.5 Sydney Airport

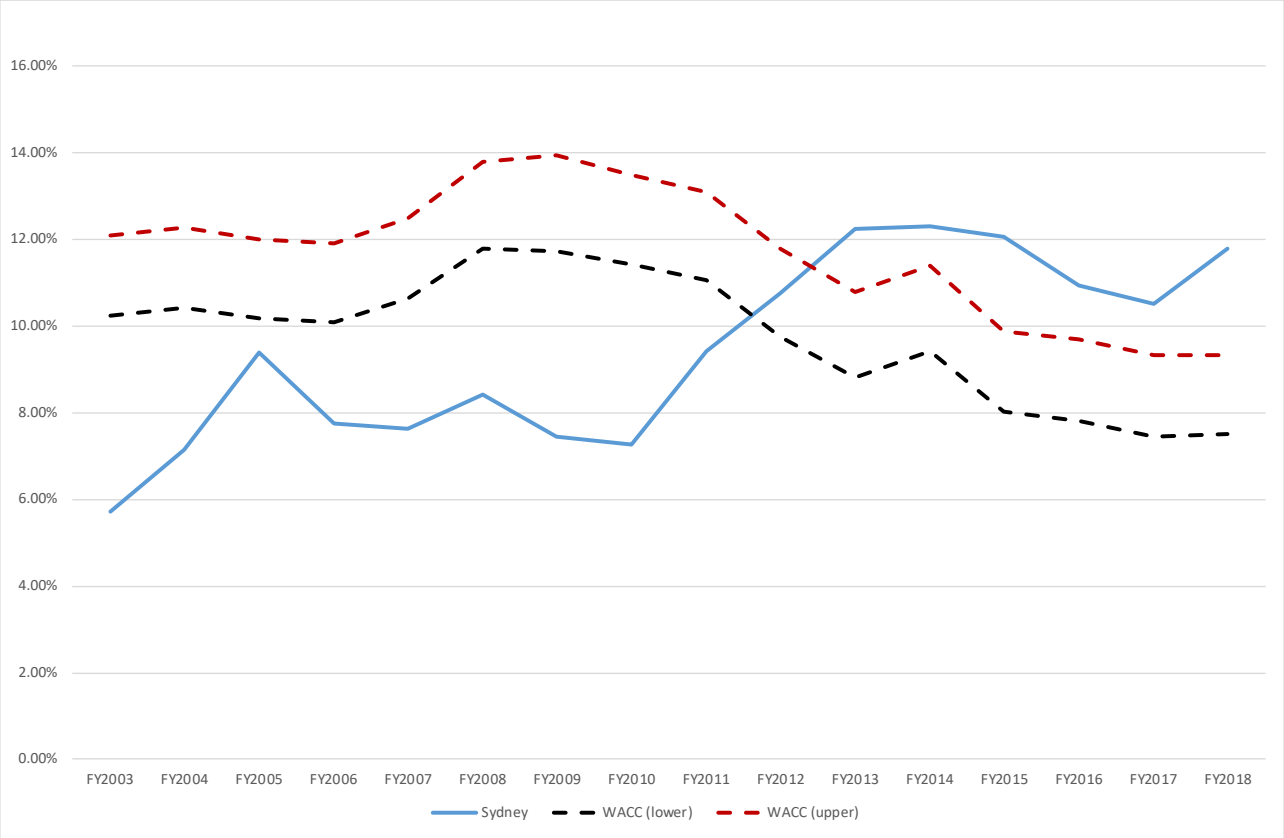
Figure 5 shows the return on aeronautical assets at Sydney airport in each year during the period 2002/03 to 2017/18.

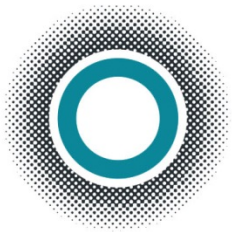
The reported return on aeronautical assets at Sydney airport has been below our estimated lower bound for the WACC of a benchmark provider of aeronautical services for the majority of the assessment period.

For the first nine years of the price monitoring regime, Sydney airport earned a return on aeronautical services below our estimated lower bound for the WACC. Since 2012/13 the returns on aeronautical assets at Sydney airport have been above the upper bound estimate of the reasonable range for the WACC.

Sydney airport's average return on aeronautical services over the assessment period has been 35 basis points below the average of our estimated lower bound for the WACC.

Figure 5: Returns on aeronautical assets by Sydney Airport





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