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ECONOMICS AND INDUSTRY STANDING COMMITTEE

INQUIRY INTO REGIONAL AIRFARES IN WESTERN AUSTRALIA

SUBMISSION BY VIRGIN AUSTRALIA

JULY 2017

The Virgin Australia Group of Airlines (Virgin Australia) welcomes the opportunity to provide a submission to the Economics and Industry Standing Committee's Inquiry into regional airfares in Western Australia. Our submission addresses those terms of reference where we believe our views may assist the Committee in conducting its Inquiry.

Virgin Australia has a strong presence in the Western Australian aviation market, offering an extensive network of both regular public transport (RPT) and charter services. Virgin Blue entered the RPT market in December 2001, with the commencement of daily services between Perth and each of Adelaide and Melbourne, followed by the introduction of intrastate services on the Perth-Broome route in September 2004. In 2014 we acquired Tigerair, which has been operating services to Western Australia since January 2008.

Our Western Australian RPT network has since expanded to include a total of 131 interstate services per week (between Perth and each of Adelaide, Brisbane, Darwin, Melbourne and Sydney, as well as Canberra during Federal Parliament sitting periods and Gold Coast on an ad hoc basis), 91 intrastate services per week (between Perth and each of Broome, Geraldton, Kalgoorlie, Karratha, Kununurra, Newman, Paraburdoo, Port Hedland and Newman), one service per week between Perth and each of Christmas and Cocos (Keeling) Islands and one service per week between Port Hedland and Denpasar. We also previously operated RPT services between Perth and each of Albany, Derby, Esperance (ceased February 2016) and Learmonth (Exmouth) (ceased October 2014) under a regulated air services contract with the State Government.

As with all markets and routes we serve, the sustainability of our services in Western Australia depends on our ability to match the capacity we deploy with the demand for our flights. Following a period of strong capacity growth precipitated by high levels of demand for air transport from the mining and resources sector, our total seat capacity on Western Australian routes has fallen by 8% since 2014. On the intrastate routes we serve, our total seat capacity has fallen by around 24% over the same period.

In general terms, it is not commercially viable for an airline to indefinitely maintain a service on a route for which revenues earned are insufficient to offset the corresponding costs. While airfares are influenced by a complex range of interrelated factors, airlines operating on a rational commercial basis will price their services in order to cover their costs and, if possible, earn a reasonable return on invested capital.

If costs are outweighed by revenue on a particular route for an extended period, an airline will inevitably look to withdraw its services and redeploy aircraft onto higher-yielding routes. For the impacted route, the result will be fewer air services, reduced competition and potentially higher airfares. In this regard, we would highlight that most of the intrastate routes we serve in Western Australia do not deliver acceptable commercial returns to Virgin Australia at current pricing levels. It is also relevant to note that between FY14 and FY17, our sale fares fell by up to 15% on seven of eight of these routes.

For Virgin Australia, the operation of a sustainable network of air services provides us with the greatest opportunity to facilitate the economic development and social cohesion that aviation brings – in metropolitan and regional communities alike – as well as deliver returns to our shareholders as a private commercial enterprise.

a) Factors contributing to the current high cost of regional airfares

As noted above, pricing on any route is driven by a complex range of interrelated factors. Broadly, the key factors comprise:

- supply of, and demand for, air services;
- costs of operation of flights; and
- competitor pricing.

Demand for travel on any particular route is influenced by the mix of corporate and leisure passengers, the seasonality of the route and prevailing economic circumstances. On most of the regional routes we serve in Western Australia, the corporate and government segment is the predominant source of demand for our services, driven in large part by the 'fly-in fly-out' workforce requirements of the mining and resources sector. It is important to note that the revenue earned on these routes under corporate contracts is crucial to the viability of our services. Without the demand from these corporate clients, it is highly probable that capacity and frequency on many intrastate routes would be lower, and it is also possible that airfares would be higher.

We have found that there is limited scope to unilaterally boost demand for our flights on these routes with price discounting, unlike routes with a greater proportion of price-elastic passengers travelling for leisure or non-business purposes. Offering deeper discounts will be unlikely to boost demand and will simply reduce the total revenue we would otherwise earn on these services, reducing our ability to cover our costs of operation.

Costs of operation include fuel, airport fees, labour, air navigation charges, aircraft leasing, catering and general administrative overhead expenditure. Such costs will vary for each route depending on fees charged by the relevant airports, aircraft type, sector length and frequency of service. The cost of fuel at regional airports is often higher than capital city airports, and while Virgin Australia seeks to minimise the need to uplift fuel at regional airports, there is a need to do so for some flights. The carriage of extra fuel adds weight to an aircraft, increasing fuel burned on the flight.

Due to a lack of scale, the costs of operation of a flight on regional routes are always higher per passenger than on routes between capital cities. With fewer passengers and frequencies across which such costs can be allocated, it is more difficult to achieve cost efficiencies on regional routes. It is also the case that these routes exhibit significant variations in passenger loads depending on direction of travel. As a result, the costs which must be recovered in each airfare on a regional sector are often greater than those applicable to capital city sectors. On the routes we serve, we generally seek to set airfares at levels that allow us, at a minimum, to recover our costs of operation. On regional routes with marginal levels of profitability, this can be difficult to achieve.

For any route, airfares and loads will vary depending on the day of the week and time of day. Flights at popular travel times will naturally attract more passengers than those at less popular travel times. Despite some flights in our regional Western Australian network recording strong loads, we would highlight that the average load across these routes during FY17 was less than 60%.

In a competitive market, prices offered by other airlines also influence the airfares we offer on regional routes. Our competitors will likely face costs of operation similar to Virgin Australia, and will seek to recoup these in setting their own pricing on these sectors.

With relatively high costs, low passenger loads and limited opportunities to boost demand through price discounting compared to some routes between capital cities, intrastate routes in Western Australia are unlikely to be commercially attractive to a low cost operator. The fundamental economic characteristics of such routes are incompatible with the business models of low cost airlines, which depend on the ability to realise cost efficiencies by operating flights in high-volume and leisure-dominated markets.

It should also be noted that comparisons with airfares on international routes to/from Perth are not valid, as the economics of such routes are entirely different to those applicable to regional intrastate routes. On international leisure routes, there is significant scope to boost demand and passenger volumes through promotional activities and price discounting. As noted above, such opportunities are limited on regional intrastate routes. It is also misleading to draw comparisons between airfares offered on international routes to/from Perth by low cost airlines, which operate at lower cost bases than the full service carriers serving intrastate routes in Western Australia.

Airport charges

Airport charges (terminal, landing and security screening fees) represent a significant proportion of airfares on regional routes. For an aircraft turnaround on these routes in Western Australia, such charges are on average around double those levied by the regional ports we serve in New South Wales and Victoria, on a cost per-passenger basis.[1]

In some cases, such charges reflect a growing trend where local councils grant the management rights of an airport to a third-party operator under long-term lease arrangements. The financial benefits derived under such arrangements provide funds which can be used for investment in other community infrastructure, while also relieving councils of the economic burden of investing in airport infrastructure during the relevant term of the lease. While this is the prerogative of these local councils (given there is no regulation governing regional airport pricing), we are of the view that communities may not be aware this practice is occurring and simply draw the conclusion that airfares are unreasonably high as a consequence of price setting by airlines.

There is also a risk, particularly with private third-party operators, that some airports may seek to over-invest in infrastructure. This could lead to significantly higher aeronautical charges for airlines, particularly at low-volume regional facilities. To ensure these charges are not higher than necessary, investment in airport infrastructure should be aligned with the needs of passengers using the facilities and demand for air services, rather than future aspirations of the airport operator. There is a need for regional airport operators to engage in genuine consultation with their airline customers in relation to the delivery of new infrastructure and the consequential implications for pricing. In a recent case with one privately-operated airport, consultation regarding new investment was extremely poor and there was a complete lack of transparency regarding pricing impacts.

Our concerns about these high charges at regional airports, and their impacts on the sustainability of air services and tourism, were outlined in our submissions in 2012 and 2013 to inform the development of the State Aviation Strategy. Despite the fact that our passenger volumes across these routes have decreased since that time, we have generally seen airport charges increase over this period. It would therefore seem that regional airport operators expect that airlines will be willing to continue to operate services at reduced levels of revenue while facing these rising costs.

[1] There is some variation in the charging methodologies applied by different regional airports. Turnaround costs have been assessed using average passenger loads during May 2017.

We are also unaware of any action taken by the former State Government to address our concerns about airport charges, including specific actions noted in the State Aviation Strategy regarding the establishment of a policy framework for master planning of local government-owned major regional airports within a state-wide aviation network-planning context (8.10 and 10.13).[2]

The Department of Transport (the Department) has, however, advised that it is currently examining the potential to develop a strategic Airport Asset and Financial Management Framework for regional airports that seek funding under the State's Regional Airports Development Scheme (RADS). We understand that such a framework would aim to identify the purchase, use, maintenance and disposal of all aeronautical assets required by the regional airport and assess monies received through airport charges, State and Commonwealth grants and council rates. Virgin Australia would welcome the opportunity to engage with the Department, airport operators and other stakeholders in relation to the development of this framework, with a view to working towards more reasonable aeronautical fees, which would provide scope for airlines to offer lower airfares on regional routes.

c) Impact of State Government regulatory processes on the cost and efficiency of regional air services

Virgin Australia currently holds two Aircraft Licences for RPT services, each with a validity of 12 months, in accordance with the State's *Transport Co-ordination Act 1966*. Obtaining these licences does not represent a significant regulatory burden from our perspective, although we would note that Western Australia is the only state or territory that has such a requirement. The Final Public Report 2015 of the Review of Regulated RPT Air Routes in Western Australia noted that the former State Government was considering legislative amendments which would allow such licences to be issued for a term of up to five years and require that licences are only issued for RPT and charter airlines operating on regulated RPT routes and/or unregulated RPT routes that are deemed strategically important by the State.[3] While Virgin Australia is pleased that the Act was amended with effect from March 2017 to allow licences to be issued with a term of up to five years, we note that the ports we serve in Western Australia preclude us from accessing an exemption to hold a licence as per the Transport Coordination (Part III Exemptions) Order 2016. It would be desirable if the requirement for RPT airlines to hold an Aircraft Licence was eliminated in the future.

As noted above, Virgin Australia previously operated services on regulated RPT routes between Perth and each of Albany, Derby, Esperance and Learmonth (Exmouth), pursuant to contractual arrangements assumed following our acquisition of Skywest Airlines in 2013. While we no longer serve any regulated RPT route in the State, it was our experience that the ongoing compliance requirements associated with the operation of services on these routes were quite an administrative burden, consuming a considerable amount of time and resources. For example, it was necessary to secure amendments to the contractual arrangements between ourselves and the State Government in relation to minor changes (15 minutes) to our schedules and the ability of our international alliance partners to offer code share services on our flights on the regulated routes.

[2] Western Australian State Aviation Strategy, pages 41 and 61.
[3] Review of Regulated Regular Public Transport Air Routes in Western Australia Final Public Report 2015, page 16.

d) Actions that the State and local government authorities can take to limit increases to airfares without undermining the commercial viability of regular public transport (RPT) services

Without altering supply, demand or costs, it is highly unlikely that the fundamental economic characteristics of regional air services in Western Australia will change. Actions by the State Government and relevant local councils to boost supply and demand, as well as reduce costs, will provide scope for airlines to offer lower airfares on these routes.

On the demand side, increased funding for tourism marketing or tourism infrastructure may assist to boost leisure travel to and within the State. Compared to Queensland, which attracted 21.2m domestic visitors and 2.6m international visitors in the year ending March 2017, 9.5m domestic visitors and 0.95m international visitors travelled to Western Australia during the same period.[4] While Queensland has the advantage of being on the east coast and is therefore more accessible to residents of, or tourists visiting, Sydney or Melbourne, the level of tourism infrastructure is significantly more developed in Queensland compared to Western Australia. With growing numbers of visitors to Australia from Asian markets, especially China, it is important that tourism infrastructure in Western Australia is capable of accommodating increased demand. State Government incentives to encourage investment in tourism infrastructure may support such development.

Increased demand for travel to Western Australia may also correspond with greater demand for travel on intrastate routes, potentially leading to an increased supply of services and the ability for airlines to realise greater cost efficiencies in these markets. This may deliver lower airfares on such flights. While funding for Tourism Western Australia has increased modestly in recent years, the Government may wish to give consideration to boosting this further. It may also like to explore directing a relatively higher proportion of marketing funds to promoting travel to regional Western Australia.

From a broader perspective, any initiatives by the State Government to support economic development across the State, particularly in the regions, has the potential to boost demand for air services on intrastate routes.

On the cost side, consistent with our comments above, regional airport operators should critically examine whether current levels of airport charges are in fact meeting the expectations of communities. Communities that are concerned about prices of air services may wish to see airport operators bring down the cost of airport charges in order to provide scope for airlines to offer lower airfares on regional routes. The broader economic and social benefits the airport delivers to the region should be taken into account in assessing the commercial success of the airport.

Regional airports should also be encouraged to seek non-aeronautical streams of revenue, such as car parking and retailing, to reduce their reliance on charges paid by airlines. Provision by the State Government of an increased pool of funding under the RADS could also limit the increase in airport charges faced by airlines in connection with new infrastructure.

[4] Results of the International Visitor Survey for the year ending March 2017; Travel by Australians: Results of the National Visitor Survey for the year ending March 2017.

Adoption by local councils of an alternative regional airport ownership model may also assist to moderate charges faced by airlines. Further to our comments above, the risk with private leasing (or private ownership) is that the lessee (or owner) will focus on a return on investment, to the exclusion of all other considerations. This may be detrimental in terms of either:

- under-investment in infrastructure to reduce capital costs and maximise returns;
- over-investment in infrastructure to substantiate higher pricing; or
- pricing set to maximise airport commercial returns without regard for the economic/social impacts on the community.

A private-lease model, which incorporates an effective access regime, may potentially strike an appropriate balance between the need for investment and ensuring acceptable commercial outcomes. The scope of an effective access regime would require consultation but could include:

- equitable access for all carriers;
- consultation obligations in relation to investment and pricing; and
- pricing parameters and price-setting methodology.

Should the State Government wish to ensure that the cost of operation of air services is reduced in order to provide scope for airlines to offer lower airfares, it should examine options for introducing regulation which would require regional airport operators to adhere to a strict price-setting methodology and set of parameters for establishing airport charges, as well as impose an obligation on airports to hypothecate aeronautical revenues to fund airport infrastructure and other aviation-related projects. Such regulation could also require that such operators publish reporting on revenue earned from airport changes, how this revenue has been utilised and how its charges compare with those imposed by airports in other states and territories with similar passenger volumes.

If the State Government is of the view that airfares offered on regional routes do not meet the expectations of the community, it may like to consider providing a subsidy to airlines or directly to the travelling public. In the latter case, we note that the Queensland Government's Local Fare Scheme for Far North Queensland provides local residents with up to $400 off a return flight when travelling between certain airports.[5]

Similarly, the State Government might like to look at whether regulation of air services would be appropriate if it wishes to achieve a particular pricing and service frequency outcome on any particular intrastate route. It is, however, unreasonable to think that airlines, as private businesses, would operate on any intrastate routes under a regulated arrangement with the State Government if such routes could not be operated on a profitable basis. In this regard, Virgin Australia was disappointed that the State Government's Final Public Report 2015 of the Review of Regulated RPT Air Routes in Western Australia failed to acknowledge the need to minimise costs faced by RPT airlines serving regulated routes. In contrast, the minimisation of costs faced by the resources sector, charter operators and the government were all articulated in the report as objectives of the former State Government's regulatory approach for intrastate RPT air routes.

[5] https://www.tmr.qld.gov.au/Travel-and-transport/Local-Fare-Scheme-Far-North-Queensland.aspx.

e) Actions that airlines can take to limit increases to airfares without undermining the commercial viability of RPT services

Virgin Australia is committed to offering sale fares in regional markets. These fares are offered as part of our regular “Happy Hour” sales promotion, with different regional markets across our network included when there is a need to stimulate demand on such routes. Regional routes are also included in our network-wide sales. As noted above, our sale fares have fallen on seven of the eight intrastate routes we serve in Western Australia over the past three years. On some markets, we have offered sale fares on more than 650 days since 1 July 2015.

We also undertake a range of promotional initiatives aimed at regional communities, such as “Kids Fly for Less”, which allows a child’s ticket to be booked at a 50% discount when purchasing a full adult economy fare to Perth. We also ran a special regional market sale campaign at the end of July, which included all intrastate routes in Western Australia.

Other initiatives have included an advance purchase sales strategy on regional intrastate routes in early 2016, implemented alongside our regular sales activity. This was introduced to encourage early bookings at low prices. We found the uptake of such fares to be poor.

We would, however, highlight that on intrastate routes dominated by corporate travellers, the scope to boost demand through price discounting is quite limited. Furthermore, we have seen our total passenger numbers fall across these routes between FY16 and FY17. In relatively low-volume markets with contracting passenger numbers, further price discounting is likely to be ineffective in stimulating demand and may see the costs of operating such flights exceed the revenue earned. The operation of flights on this basis is unsustainable and would likely lead to the reduction or withdrawal of services on these routes over time, with a detrimental impact on the relevant regional communities.

Virgin Australia continually monitors the commercial performance of the routes we serve, in order to ensure that capacity deployed in each market is largely aligned with demand. Our services between Perth and Broome provide a key example in this regard, as a route which has typically been dominated by passengers travelling for leisure or non-business purposes. Since June, we have seen a significant increase in demand for our services on this route from our corporate customers in the mining and resources sector, to which we have responded by scheduling additional frequencies. Subject to demand, we may also deploy larger aircraft on some services in the future. This additional capacity will assist to accommodate demand from all sectors of the market, including those travelling for leisure, supporting the tourism industry in the region.

f) Recent actions taken by other Australian governments to limit regional RPT airfare increases

While Virgin Australia is not aware of any specific actions by other Australian governments to limit regional RPT airfare increases, the Federal Government has undertaken a number of initiatives to boost the competitiveness of the Australian aviation industry by removing unnecessary regulatory burdens, eg the recent Aviation Rescue and Fire Fighting Services Regulatory Policy Review. Elimination of unnecessary costs for airlines can assist to keep airfares lower than they otherwise would be.

More broadly, Tourism Australia’s destination marketing activities support growth in inbound visitation to Australia. This has the potential to see more travellers visit regional destinations, boosting demand for services on intrastate routes. With demand to support more services, airlines have a greater opportunity to realise cost efficiencies, providing scope for lower airfares.