REGAIR Submission 90
Recv'd 31 July 2017

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Dear Dr Worth;

As per our discussion on 28 July 2017, please find below a submission into the airfare inquiry. Please note that this submission will focus on the Broome - Perth route. Some factors may be translatable to other routes. Whilst I have tried to address the points in the order of the terms of reference, it has become scrambled in many places as many points are so intricately linked.

a. factors contributing to the current high cost of regional airfares Broome – Perth route;

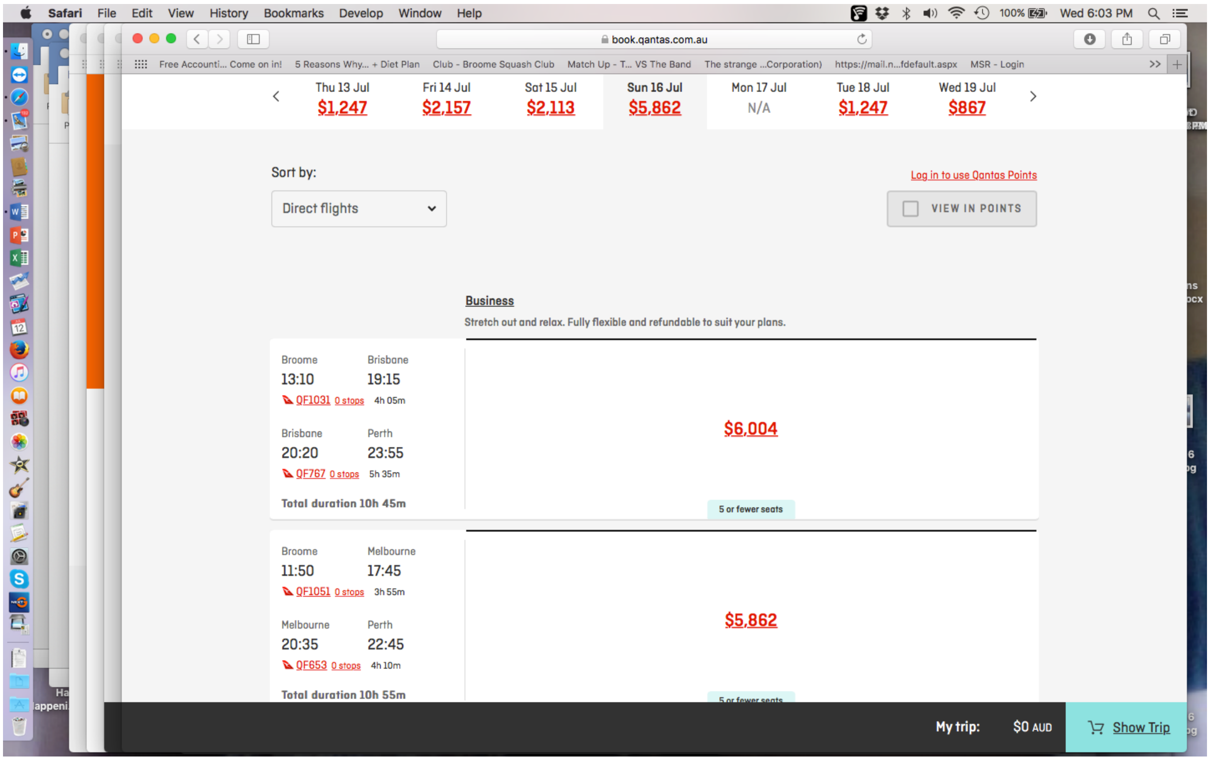
<u>Market Failure</u>
There is one simple reason for the high airfares on the Broome – Perth route and it is "market failure". A definition for a free market is provided below:

"One view is that a free market is a system in which the prices for goods and services are determined by the open market and consumers, in which the laws and forces of supply and demand are free from any intervention by a government, price-setting monopoly (or duopoly), or other authority.
(https://en.wikipedia.org/wiki/Free_market)"

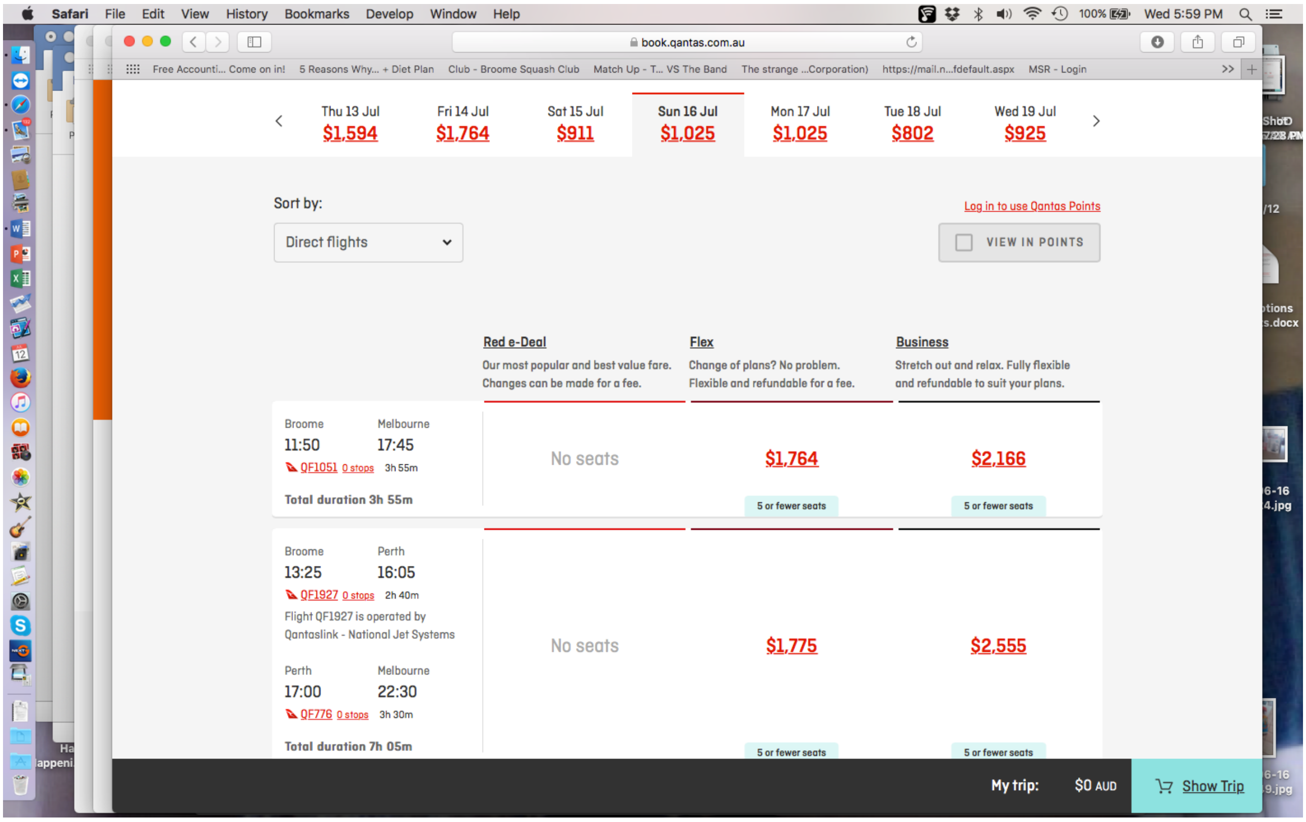
In the current market, consumers do not have any ability to set prices for goods and services through a normal demand and supply situation. How could they when we end up with the infamous $6000 Broome to Perth airfare (see Screen Shot A) where fliers were forced to fly business class from Broome via Melbourne to get to Perth?

As a total contradiction, Screen shot B shows that if you wanted to fly to Melbourne from Broome it would only be $1,775 but you could fly via Perth. Why wasn't the flight Broome to Perth available as a single leg at a reasonable price if you searched for that!!!! The airlines are dictating what options are available to reach a specific destination, not based on availability but on what they wish to sell.

Screen Shots A and B are the most explicit example of market failure where the supplier of goods not only dictates the prices to the consumer but also dictates to the consumer which products they can choose.



Screen shot A: Showing infamous Broome – Perth $5,862 airfare - Sunday 16 July 2017



Screen shot B: Contrasting Screen Shot A, it appears that you can fly direct Broome – Perth but only if you catch a connecting flight to Melbourne????

Why is the market failing?

Two key issues have affected the Broome – Perth leg:

1. Loss of competition after the takeover of Skywest by Virgin, and,
2. Introduction of FIFO workers onto a leisure route.

1. Skywest was taken over by Virgin in 2013. In assessing the potential for the lessening of competition due to the takeover, the Chair of the ACCC, Rod Sims stated *''The ACCC 's view is that this acquisition is unlikely to lead to a substantial lessening of competition in any relevant market, primarily because the direct overlap between Virgin Australia and Skywest's services is limited to a single route between Perth and Broome,''* (http://www.smh.com.au/business/virgin-takeover-of-skywest-gets-all-clear-20130130-2dm5l.html).
   Only one route would be affected by the lessening of competition. How true and prophetic were the words of the most informed person in the area of competition! Airfare sales between Perth and Broome have been very few and far between them since the takeover of Skywest. The competition has lessened as predicted.

2. Up until around 2007/08 Perth - Broome was classified as a 'leisure route' by the airlines. Of the 400,000 or so people that travelled through Brome International Airport (BIA) only 1-2 % were FIFO. Over the next 8 years this changed significantly so that at its peak (around 2014/15), in a given week, up to 25% of the throughput was FIFO (these are based on verbal comments from CEO BIA). The Perth – Broome leg had transformed into a combined corporate – leisure route, which is what it is today.

   The impact of the FIFO market is that it provides guaranteed regular numbers of non-discretionary customers at a non-discretionary price eg, the workers have to come to Broome and can not choose an alternate destination based on the cost of the product. For the airlines, once they have a FIFO contract in place, no marketing is required to attract the FIFO workers, just provide the service up to a price that the customer can bear, with a minimal level of service that the customer will accept. Any business that has a guaranteed number of clients at a fixed price lacks competition and has no incentive to reduce prices once the operating costs and costs of capital are covered. This is exaggerated when there is limited or no competition to also put downward pressure on prices.

   On leisure routes, tourists make discretionary decisions about where they wish to visit based on destination desirability and also cost of access. If access costs, such as airfares are too high, airlines will not be able to cover operating and capital costs. Airlines can respond in two ways – destination marketing or price discounting as airlines will be competing for the customers to utilize their services based on the value of their service, but also on the perceived value of the destination.

Consequences of market failure

When there is market failure, business can focus on optimizing internal business process, often without regard to the price of the service to the consumer. Market failure was graphically illustrated in Screen shots A and B.

How are the airlines responding to market failure on the Broome – Perth route

In a properly functioning market there is a reasonable balance between supply and demand. For example, as demand increases to the point of almost saturation of supply, the supplier typically responds by bringing more services to the market to try and grow the market. If supply is limited too much and the prices get too high, a functioning market would then encourage the entrance of new supplier which would in turn bring the prices down. This does not happen on the Broome – Perth route.

At present the airlines are 'comfortable' running at high load factors and getting excellent rates of return on capital deployed on the Broome – Perth route. At a briefing in April 2016 the Qantas regional manager WA proclaimed that Qantas had reduced capacity on the Perth -Broome route by 18% but passenger numbers had only dropped 8%. They achieved this capacity drop by replacing a regular Boeing 737 service with a Boeing 717. This increased the load factors of -/+ 65% on the 737 to over 80% on the 717 giving Qantas a higher return on capital whilst at the same time reducing the service they provided to Broome. 717 aircraft were still flying the Perth - Broome during the extremely high demand July school holidays, rather than being upgraded to 737 aircraft.

The airlines are responding to market failure by optimizing their internal business processes to maximise the return on capital, and the consumer is only a marginal input. On the Broome - Perth leg, the airlines can do this with only limited regard to competitive and market pressures. This result is that the airlines set airfares that produce the best return on capital, not airfares that maximise the number of tourists (within reasonable cost constraints). The airlines internal financial process and return on the cost of capital targets are the main driver of high airfares.

Airline excuses for high costs

The airlines are very good lobbyists and also very good at confusing the argument with irrelevant statistics.

"Cost of running smaller planes is higher on cent per kilometre basis" – the choice of running the smaller planes was made by the airlines so that they could achieve higher load factors. So the cost is higher per kilometre but they are running load factors that significantly exceed their benchmark cost of capital.

"Airfares are on sale for up to 189 days per year" – Qantas has quoted this statistic at previous meetings. However it needs to be acknowledged that there is a difference between a reasonably available airfare at a reasonable price, rather than an airfare that is reduced from an already very high price to just a high price.

"A low cost airline from Perth would need an anchor town at the other end with a population of at least 150,000." – the flights from Perth to Bali do not carry any Indonesian passengers from Bali to Broome, effectively making Bali a zero population end point as it provides no organic customers to the airlines on the Bali to Perth leg.

b. impacts that high-cost regional airfares have on regional centres- from a business, tourism and social perspective;

Perth is the major source of tourists to Broome accounting for up to 60% of guests that stay in Broome accommodation. Between 20-30 % of visitors to Broome are from the east coast. The east coast visitors can be broadly classified as 'Bucket Listers' where they have a one-off desire to visit Broome and Kimberley. Their trips have been planned for a long time and may include a longer trip such as a cruise or land based tour. The flights are potentially a small cost component of the whole holiday and these visitors are not so impacted by higher airfares.

Alternatively the Perth market is more discretionary where visitors might visit the same location several times, not just to tick off the "bucket list". There can be several destinations vying for this limited tourist dollar. For example; Broome might be competing with Bali, Phuket or another south east Asian destination. When a potential guest is doing the research, one of the first items they will investigate is the flight costs. It is at this initial and early stage that Broome gets knocked out of the equation as a potential destination. The outcome is that potential intrastate tourists end up travelling internationally, taking their tourist dollars overseas and not spending locally. Australian Bureau of Statistics indicates that the September quarter occupancy levels of Broome accommodation has dropped from 80% in 2011 to just under 60% in 2015. It appears to have rebounded slightly in 2016 but we are waiting for updated data. This is a significant impact and cannot be sustained in the longer term.

It is also important to be aware of the current statistics regarding consumer behavior and put it in context. Recent figures were that approximately 1 million people would fly from Perth to Bali in the current financial year. That is an incredible number especially when you consider the impacts if only a small percentage of that amount holidayed within the state. Broome needs to increase the amount of visitors by about 50,000 – 70,000 per year and we will be quite busy and generating a lot of economic activity. This is only 5-7% of the tourist visiting Bali from Perth. So we only want a small amount of the discretionary tourists going to Bali to come to Broome, highlighting that Bali is a major competitor and a market that is an important benchmark and comparison for Broome.

The airlines enjoy the regularity and lack of price sensitivity of the FIFO clients, however FIFO workers **displace tourists** which in turn severely impacts on the tourism industry of Broome. There is much misinformation that is put out about the benefits of FIFO workers on airline routes. More FIFOs on a service may underwrite the service but an increasing number of FIFO workers will not put lower pressure on airfares but actually the reverse. So whilst the FIFO presence may underwrite the service, their presence distorts market prices and doesn't put the airfare prices in the domain of the tourist consumer. The FIFO presence in the market displaces the discretionary tourist consumer dollar who can choose an alternative destination at a cheaper price.

A key financial management benchmark of airlines is the management of the cost of capital, eg provide the lowest cost of capital (smallest plane) to achieve the maximum return (highest airfares). FIFO companies often make block bookings on planes at medium to higher level airfares. Once an air route reaches the benchmark return on capital there is little need to discount airfares to achieve more passengers as there is a latent demand that will always arise from the local community for personal, medical or other purposes and people will be required to pay the higher airfare due to necessity. Once minimum return on capital benchmark is achieved, these higher airfares provide an extremely high level of profit. On a route with a high number of FIFO workers this benchmark will be reached with fewer passengers as the FIFOs paid higher airfares. Therefore the effect is that tourist passengers are displaced by the FIFO workers because the FIFO workers are more valuable to the airlines as customers and there is no incentive to chase the tourist customers through cheaper airfares.

More recently, Shell announced that they were going to have quite a few workers using the Perth – Broome route. To try and keep airfares down they were going to buy the more expensive flexible airfares for their workers rather than buying the cheaper fares, with the idea of leaving the cheaper fares for the locals or tourists. Whilst it was a noble idea I would suggest from my current experience in a yield based industry that their intentions may have been a little misguided. Shell put this proposal forward on the idea that there is a fixed quota of seats at each price point on any given plane. This is however counter-intuitive to the operation of a yield based business. For example in my business of a resort, I only sell cheap rooms if I have not met targets. If I know that I have a regular group booking, which I do in many periods, I will not offer cheap rates over that period as I have met my budgeted income targets for the resort as a whole. If I start discounting room rates, I might have to also provide the discount to the group booking, which in turn means that I need to sell more rooms overall to meet the same gross income target. Airlines will be the same as yield is the key financial driver, and if they meet their income requirements on a given route, there is not incentive to provide any discounted airfares at all.

Scenario 1

For example, let's assume there are 40 FIFO workers on a plane (Fokker F 100 with 108 seats) on any given day and the airline has cost of $20,000 each way for the plane and a notional return on capital of $8,400 per flight. The airline will have a fixed operating cost per person for ticketing, check-in, baggage handling, over and above the cost of the plane etc. – let's assume $140 per person.

If the 40 FIFO seats were purchased at $640 per person, the airline has nearly met its operating costs just on the FIFOs (40 x $640 - 40 x $140= $20,000) – fixed costs are covered. This will leave about 68 vacant seats, however the airline will assume that there is also a latent need in the community where people will have to fly almost regardless of the price (eg government business, medical or family reasons, urgent business, returning to school) – let's assume a figure of 20 people and let's assume another 15 people who are not too price sensitive and are flying in for a once in a lifetime holiday – 35 in total. That gives a fixed figure of around 75 seats filled leaving 33 unfilled.

Let's also assume a standard airfare of $380 which is what I paid on 26 June.

Therefore the profitability of the plane as this point is: income (excluding FIFO) (35 x $380 = $13,30) less costs (35 x $140 = $4,900) is $8,400, which meets the required cost of capital.

However let's assume the airline wanted to increase utilization by selling cheaper tickets and assuming the FIFOs still paid the higher prices and covered the fixed operating cost. Let's assume a typical 'sale' price of $280 which is commonly offered by Qantas. The airline would then need to sell 60 seats, instead of the pre-existing 35 (in excess of the 40 FiFO seats) to achieve the same profitability (eg 60 x $280 – 60 x $140 = $8,400). Therefore why bother discounting when you can achieve the same profitability and meet return on capital requirements with only 35 passengers paying the higher price?

Scenario 2 – Low FIFO airfares

Lets assume that the 40 FIFOs negotiated a lower price of $400 per person and assume the latent demand of 35 people pay a reduced price of $280 per head. Income = 40 x $400 + 35 x $280 = $25,800, which covers fixed flight costs and contributes $5,800 towards meeting the cost of capital target of $8,400, leaving a deficit of $2,900 to be recouped across the remaining 33 unfilled seats ($87 per seat plus fixed costs of $140) to give a cost of $227 per seat. As tourism demand is quite price elastic the airline would have to sell all the remaining seats at a price point where the tourists filled the plane.

So counter intuitively, it could potentially help drive down airfare prices if companies like Shell purchased the cheapest airfares they could negotiate. Airfares are based on the return on capital imperative, not a fixed number of seats at set prices.

(NB: these scenarios are very simplistic and all figures are totally assumed. However the price impact effects are the relevant point. I flew on a Virgin plane on 26 of June paying $380 for my airfare. There was 82 passengers on the 125 seat plane and approximately 40 were FIFO. Given the plane was one third empty, where was the incentive to fill the remaining seats?)

Irregardless of the previous scenarios outlined, there is one unknown that also has some impacts but the details are hidden in confidential contracts. This unknown is the rate of rebates that the airlines pay to companies. What is publically touted is the headline airfare that the companies pay, not the net figure after the airline rebates to the company.

FIFOs generally
This submission is not aimed at denigrating FIFO workers but just acknowledging in a potentially objective manner the impact that they have on regional airfare prices. We only need to look around the state to see the contradiction of the benefits to airfares that was promised by having FIFO routes versus the actual outcome eg airfares increase on FIFO routes.

Reduced capacity
The other indirect outcome of the higher airfares is that the airlines have also significantly reduced capacity to maximize return on assets deployed. The airlines try to maintain higher airfares by reducing supply, even though there is a fixed minimum demand. The reason behind this is that the profitability of flying a smaller plane (eg 717) at a utilization of 95+% is much better than the profitability of flying a larger plane (eg 737) at a lower utilization of 75-80%. To increase the utilization of the 737 the airline would have to offer lower airfares to encourage more discretionary consumers.

Related anecdote: 13 May 2017. A guest had inadvertently lost their false teeth in the surf at Cable Beach. They rather desperately had a new set sent from Perth via Express Post. They checked with the Post Office everyday for five days straight and were advised each time that the planes were too full so that the freight was removed from the plane.

This raises the question of why aren't the airlines putting on extra capacity via a larger plane when they are having to judge the load capacity of the smaller plane to the nearest 100kg

Historical impact

It is quite intriguing in the management of the state that we often fail to look at the lessons of history. Broome has faced two near death experiences in the last 30 years based similar on our fragile airlinks. The pilots' strike of 1989 caused massive disruption to the newly opened Cable Beach Club Resort and the rest of Broome. Some 13 year later the collapse of Ansett was catastrophic for much of regional Western Australia and my resort figures show that it took several years for the Broome economy to recover.

Some 14 years later Broome is again facing a major issue based on the fragility and our dependence on airlinks for social and economic activity. Rather than the big bang impact of the two previous impacts, this has been a slower and more tortuous one spread over several years. As per previous impacts, it is pervasive and severe. Housing prices are down considerable, houses for lease and rental are continuing along long term highs, numerous shops are vacant and many trades and services have left town. Competitively, in the off season we are offering room rates that are cheaper than when we first came to Broome 13 years ago, even though costs have risen considerably. We are in the process of trying to buy market share in a shrinking market through price reduction. We should be increasing the size of the market overall by offering very cheap prices, but normal market forces are prevented from functioning due to the distortions imposed by higher airfares and capacity restrictions.

Worrying anecdote

Recently it was announced that FIFOs coming in for the Prelude project would be accommodated and housed at the Cable Beach Club Resort (CBCR) for their transit requirements. From my business experience, these contracts are usually entered into at very low margins, with almost profitless turnover. They are a means to maintaining staff and services. Reading between the lines, this suggests that CBCR is forecasting ongoing downturns in the tourism sector and CBCR has 'purchased' turnover to ensure that it maintains services. The worrying aspect is that the Club is our premier resort and actions like that are more typical of the more corporate focused providers such as The Oaks properties in Broome. CBCR is the iconic resort in Broome and it should be one of the last properties that needs to chase low margin corporate bookings to maintain. This action worries, no, scares, me significantly about the potential for next tourist season.

c. impact of State Government regulatory processes on the cost and efficiency of regional air services;

No comment to make on this point.

d. actions that the State and local government authorities can take to limit increases to airfares without undermining the commercial viability of RPT services;

The important aspect to resolving the high cost of RPT services is to understand that there is no blanket solution that will address the issues on all routes. Western Australia has quite a variation in route types (regulated, unregulated and protected) and it is envisaged that a different solution might be required for each route. It is probably inefficient for the government to take on the risk of developing and implementing a solution for each of the many different routes. A more suitable approach might be a 'fund-on-application' type approach where proponents put forward proposals for a route. Similar to Royalties for Regions, the administrators of the fund would evaluate the merits of each proposal based on established criteria and the implementation risk would pass onto the proponents. See section F about what Queensland did.

The key question is 'What is commercial viability?'. Commercial viability should be identified as when there is a reasonable balance between supply and demand and a properly functioning market is in place, as per the previous definition. The reality is that there is significant market failure in place, especially in the Perth – Broome leg. This failure is having a significantly detrimental effect on the whole community and is affecting the viability of other business, especially in the tourism sector, as well as social, medical and liveability aspects. It would be expected that the airlines would argue that any drop in their profitability would affect the commercial viability. However it is clear that the estimated margins they are earning are quite significant, especially when compared to prices charged for a comparable service on the east coast.

The argument might be put forward that in the implementation of such a fund that the government is interfering in market forces. However the alternate argument is that the government, which is representing the whole community not just a specific sector, actually has on obligation to step in where there has been market failure and where it is identified that the community, consumers and business are suffering as a result. This alternate argument is quite compelling.

As an example, it is being investigated whether a charter service could be set up between Perth and Broome through a collaboration of accommodation operators in Broome. Funds from a government support fund could potentially assist with the initial set up, marketing and perhaps some underwriting costs. This would not be an RPT but a charter. The idea of such a charter is to provide downward pressure on airfares but also to put extra capacity into the market and allow free market forces to work. It could be easily argued that due to the high barriers to entry that the government should step in to assist in the development of a properly fucntioning market.

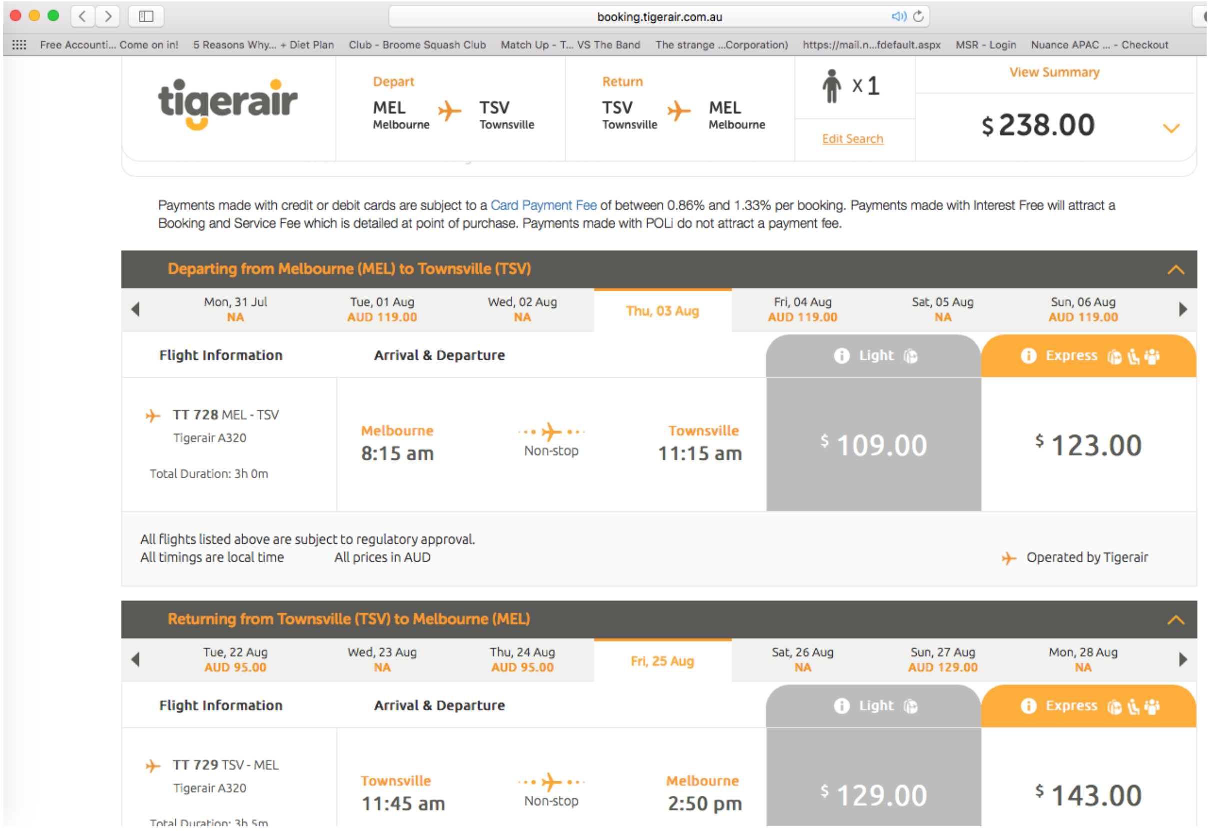
The most important part of any action by state government authorities is to make sure that any solution is a bottom up approach where information is sought and acted upon based on data provided by on ground operators and a good business case needs to be put forward. It is also important to understand that institutions like Tourism WA and Regional Tourism Organisations (RTOs) and possibly local government may not be suitable organisations to be involved in the implementation of such solutions. Tourism WA and the RTOs are predominantly marketing organisations and have neither the experience nor expertise in these areas. The local Broome Shire has shown a limited understanding of the importance of the airfare issue specifically to Broome by only providing a very brief (2 page) submission to this enquiry. More suitable organisations are industry based organisations where there is a financial accountability and responsibility such as the proposed rebadged Broome Tourism Industry Leadership Group Inc.

e. actions that airlines can take to limit increases to airfares without undermining the commercial viability of RPT services; and

With reference to the Broome – Perth route unregulated route, airlines have no incentive to take any action to limit airfare increases on this RPT route. The route is subject to market failure, as discussed previously, and there are not true competitive forces as should be encountered in a free market. As present the airlines are doing the best they can to increase airfares to maximize profitability on this highly commercially viable air route.

f. recent actions taken by other Australian governments to limit regional RPT airfare increases.

The Queensland Government has set up an Attracting Aviation Investment Fund (http://statements.qld.gov.au/Statement/2017/2/22/direct-flights-from-melbourne-will-land-jobs-economic-boost-for-townsville) which announced in February 2017 that it had secured direct flights from Melbourne to Townsville. This distance is approximately 2,600 kms comparable to that for Perth to Broome. Whilst the details of the agreement are not fully known, Screen Shot C highlights prices that are achievable (plus an extra $25 on each leg for a 20 kg piece of luggage).



Screen Shot C; Airfares Melbourne to Broome - Tigerair

END

That concludes this submission. I apologise that the submission is not up to my preferred professional standard but it will be updated and simplified for the hearings when the committee visits Broome in August. This issue is way too important to give it only lip service and Broome desperately needs to develop a constructive way forward.

Please do not hesitate to contact me if you have any questions or require clarification.

Yours faithfully,

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28 July 2017
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