

**AIRSERVICES AUSTRALIA DRAFT PRICING NOTIFICATION  
REGIONAL EXPRESS SUBMISSION TO THE ACCC**

**MAY 2011**

**1. Introduction**

This submission is provided to the ACCC by Regional Express Holdings Ltd in response to the ACCC's Issues Paper of 7 April 2011 seeking comments from interested parties in relation to the Airservices Australia draft pricing notification of 7 March 2011.

**2. Background about Regional Express**

Regional Express (Rex) was formed in 2002 out of the collapse of the Ansett group, which included the regional operators Hazelton and Kendell Airlines, in response to concerns about the economic impact on regional communities dependent on regular public transport air services previously provided by Hazelton and Kendell.

Rex (a wholly owned subsidiary of Regional Express Holdings Ltd) is Australia's largest independent regional airline operating to/from 3 capital city airports (Sydney, Melbourne & Adelaide) and 31 regional airports from across South Australia, Victoria, Tasmania, New South Wales and Queensland.

Rex operates a typical regional hub and spoke model with extensive services from Sydney, Melbourne and Adelaide airports. This is in addition to a small regional hub from Townsville in North Queensland, where the Rex Group operates a mix of regulated / non-regulated RPT and fly-in-fly-out charter.

The provision of regional air services is not only critical to regional Australia, but it is also critical to Australia's national interest. Since Rex was formed in 2002, we have witnessed the demise of some 9 regional airlines which illustrates the fragile

nature of this industry. Rex has survived due to its intense focus on efficiency that has driven significant activity level increases over the past 9 years.

Importantly, these activity level increases have directly benefited regional communities through affordable fare pricing and increased flight frequency. Rex's philosophy towards regional air services is summarised in the following public statement on its website:

*"Rex has its roots firmly in the bush and in country Australia. Its tagline boldly affirms that 'Our Heart is in the Country'. Rex believes that the bush needs and deserves an air service of quality that provides good connectivity with capital cities at affordable prices. Rex seeks to fulfill these expectations. Since its formation, Rex has steered a course balancing the needs of regional communities for extensive and affordable air services and to be economically viable and sustainable."*

Rex is an efficient competitor in regional aviation. The average Rex ticket price paid by its passengers is today lower than it was when Rex first commenced operations in 2002.

As a result of Rex's unique approach, when comparing back to FY03 (Rex's first full financial year) we have seen both passenger numbers and flown MTOW (total kg) increase by some 40%. This has directly translated into significant increases in both Airport and Airservices revenue due to these activity levels underpinning the recovery of service costs.

### **3. Airservices Draft Pricing Proposal**

Following the Airservices publication of its 'Draft Pricing Proposal' in December 2010, Rex welcomed the consultation and provided Airservices with relevant feedback in February 2011. The summary of the Rex position to the Airservices 'Draft Pricing Proposal' was as follows;

- Rex agreed with the enroute charge proposal
- Rex agreed with the terminal navigation proposal with the proviso that the cost of the Radar Direction is removed
- Rex did not agree with the ARFF charge proposal and would like to see provision made for aircraft for below category 6. Consideration should be given to the fact that increases to fund future services will in the vast majority of cases not benefit commuter aircraft.

Rex's position remains unchanged.

#### **4. Issues on which the ACCC is seeking comment on**

Not all specific issues are relevant to Regional Airlines however Rex would like to provide some additional comment to some of the specific issues that have been raised by the ACCC.

##### **4.1. Pricing Period**

The ACCC seeks comment on the appropriateness of the period covered by Airservices' price proposal. In particular, the extent to which the long term approach to pricing provides:

- industry stakeholders with the appropriate level of pricing certainty
- Airservices with appropriate incentives to achieve greater cost reductions.

Regional Express supports the 5 year term of the Airservices draft pricing notification as this provides adequate pricing certainty for longer term network decision making.

However it should be noted that during the current 5 year term, (2006/07 to 2010/11) Rex's average ticket price paid by its customers was actually lower than the prior 4 years. It has therefore been Rex's lower pricing that has stimulated demand that has been the catalyst for both Rex's activity and passenger growth with Rex therefore wearing the full cost impact of the Airservices increases whilst Airservices enjoyed the activity increases and subsequent additional revenue.

## **4.2. Consultation Processes**

The ACCC seeks comment on the effectiveness of Airservices' consultation processes in its development of its price proposal. In particular, the extent to which:

- Airservices has provided industry with sufficient information in the course of its consultations
- interested parties have been provided with, and taken up, the opportunity for Airservices to provide briefings about the detail of individual projects
- the need for new or increased services has been consulted on with the relevant regulatory bodies, such as CASA, as well as Airservices' users. Also, the extent to which these consultations consider the type, cost and price for those services.

Rex recognises and acknowledges the consultation process that Airservices has followed and the efforts to consult with industry through various forums. It is essential that this process continues.

## **4.3. Activity Forecasts**

The ACCC seeks comment on the reasonableness of Airservices' activity estimates.

Rex operates to 31 regional airports in total. However the IATA forecasts for "Regional Airports" are not reflective of the regional Airports that Rex serves.

In relation to regional airport activity forecasts provided by IATA, Rex views these as very conservative, however the "regional airports" definition is entirely reflective of the smaller regional airports served by Rex. Rex believes that the IATA forecasts are therefore too broad and not reflective of the regional aviation landscape in Australia which is unique. A combination of capacity, cost and economic conditions will determine 'regional' passenger growth into the next 5 years. When examining Rex's situation as Australia's largest regional airline, it

encountered the global pilot shortage in FY07/08 that was quickly followed by the GFC in FY08/09. Capacity levels have remained relatively constrained post the GFC, in part due to cost pressures (such as fuel) and in part due to demand not fully recovering post the GFC. These unique conditions bode well for Rex's future passenger growth because if Rex was to grow its total network passenger numbers by 16% it would only return to the passenger number levels it experienced in FY07/08.

The passenger demand impact (Page 55 of Draft Pricing Notification, Chart 8) is also not reflective of Rex's operations due to Albury airport being the only relevant airport to Rex. It should be noted in the case of Albury that, following the introduction of the Virgin Blue E-jet services between Sydney and Albury, total market capacity increased by more than 100,000 seats per year. In this situation (like many others) it is entirely the total market capacity increase and subsequent drop in the average ticket pricing that has stimulated passenger numbers.

It cannot be argued by Airservices that "rising nominal prices together with rising demand is evidence of its prices not having a material impact on demand". The airlines are incurring increased air navigation costs without any ability to pass the increases through to the passenger which simply contributes to an unsustainable situation.

#### **4.4. Building Block Model**

##### **Capital Expenditure**

The ACCC seeks comment on the efficiency of Airservices' proposed capital expenditure program, including:

- the adequacy of Airservices' capital expenditure to date in meeting the needs of users, including whether sufficient capacity has been provided
- the efficacy of Airservices' capital expenditure as demonstrated by increases in capacity, reliability, safety and quality of services
- the appropriateness of the capital projects included within the proposal
- the appropriateness of the estimated costs associated with the capital projects included within the proposal
- the appropriateness and effectiveness of the decision-making process undertaken by Airservices in determining the capital projects to be undertaken over the period covered by the proposal
- the extent to which Airservices' capital expenditure is driven by regulatory requirements, such as requirements by CASA or international policies.

The Capital expenditure program includes costs relating to the Ministerial Direction. While it is recognised that this is provided as part of the risk sharing principle as applied to regulatory change and that any cost overrun would be rebated to industry, Rex is strongly opposed to the inclusion of this particular cost. The environment for the introduction of new ATS has changed considerably since the Direction was issued in 2004 and Rex feels that once the correct process of aeronautical risk assessment is followed through the Office of Airspace Regulation, it is extremely unlikely new surveillance services will be required on the scale outlined in the CASA report.

Industry consultation of any sort has yet to take place on this initiative and it is premature to provide funding for it at this stage.

## **Rate of Return**

The ACCC seeks comment on the appropriateness of Airservices' proposed rate of return on capital.

Does the proposed return on capital reflect an appropriate benchmark given the risks borne by Airservices?

Whilst the risk born by Airservices is understood, a rate of return in the order of 9.95% represents an almost risk free rate of return and for this reason it is considered high. A return of around 2% above that of an official industry rate is considered more reasonable.

## **Risk sharing arrangements**

The ACCC seeks comment on the appropriateness of the risk sharing arrangements embodied in Airservices' price proposal, particularly relating to the trigger mechanisms for review of pricing.

The ACCC is also interested in understanding the extent to which the risk sharing arrangements may result in an increase or decrease in the risks borne by Airservices and its users.

Rex is supportive of the risk sharing arrangements proposed as detailed on page 16 of the Draft Price Notification.

#### **4.5. Pricing and structure of prices**

##### **Pricing across services and user groups**

The ACCC seeks comment on the expected impact of the current proposed price path on demand for each of the regulated services.

In particular, the ACCC is interested in stakeholder views on:

- whether full cost recovery for all services is achievable
- whether full cost recovery for all services is a desirable outcome for interested parties
- whether the timing and magnitude of the proposed price changes for each of the services is appropriate
- how an inability to recover shortfalls from en route services would affect Airservices' incentive to invest at loss making locations
- any alternative ways to structure prices or recover costs, taking into account the likely efficiency and equity outcomes of those alternatives.

Also as mentioned earlier, Rex does not agree with the ARFF charge proposal and would like to see provision made for aircraft for below category 6. Consideration should be given to the fact that increases to fund future services will in the vast majority of cases not benefit commuter aircraft.

## **Basin approach to terminal navigation charges**

The ACCC seeks comment on:

- the appropriateness and efficiency of the application of a capital city 'basin' approach to charging for TN services
- whether any subsidy accurately reflects positive spillovers or externalities generated by the basin airports
- the expected impact of removing the basin pricing approach on users of both secondary airports and the major capital city airports.

Rex continues to support this approach.

## **Allocation of costs**

The ACCC seeks comment on whether the proposed method of allocating direct costs is appropriate.

In particular, the ACCC is interested in stakeholder views as to whether Airservices' stated method of standardisation (using the standard costing method) provides a reasonable indication of the direct costs of providing services.

Rex is comfortable with the methodology used by Airservices to attribute Direct Costs.

The ACCC seeks comment on whether the proposed method of allocation of fixed and common costs is appropriate.

In particular, the ACCC is interested in stakeholder views regarding the advantages and disadvantages of this approach, and alternatives to the proposed method of cost allocation that achieve the desired efficiency, equity and price stability outcomes.

Rex is also comfortable with the methodology used by Airservices to attribute fixed and common costs.

## **Basis of charges**

The ACCC is seeking stakeholder views on both the existing system of weight based charges for each of the service lines, and the proposed changes (i.e., application of average MTOW and the weight cap).

In particular, the ACCC is interested in stakeholder views on:

- the extent to which costs vary as a result of weight
- whether the basis for charging, and the specific settings are appropriate
- whether there are alternatives to the basis of charges that would more accurately reflect capacity consumed.

Rex supports the existing system of weight based charging.

## **En route services**

The ACCC seeks comment on:

- the impact of Airservices' basis of charging for en route services on airlines' incentives for investment
- whether Airservices' projected timeline for establishing structure of en route pricing is appropriate.

Rex accepts the current proposal model and is comfortable with the timeline for any further development. Further development must include extensive and timely consultation with industry.

### **Charges for non-aviation ARFF call outs**

The ACCC seeks comment on the appropriateness of the proposed call out fee for non-aviation call outs, and the refunding of these fees to customers.

Rex strongly supports this proposal including particularly the rebate of all revenue back to aviation customers.

### **Timing of recovery of capital costs**

The ACCC is seeking comment regarding

- what Airservices seeks to achieve through any prefunding of capital projects
- how any prefunded capital projects are accounted for
- alternative methods of funding capital projects that would achieve Airservices' stated aim of providing price certainty for users, and address any transparency and 'equity over time' issues that users may have in funding projects before they have been completed.

Rex is content with the proposal as articulated based on the advice that significant prefunding of capital expenditure is not included. Significant prefunding will add to ticket prices in advance and may in turn affect demand.

### **Impact on users**

The ACCC is seeking comment on whether Airservices' estimated impacts are an accurate reflection of the likely impact of the price changes on your organisation.

The ACCC is interested in stakeholder views on the expected impacts of Airservices' proposed prices and price structure, to the extent that they differ from those estimated in the price proposal.

Impact tables on page 54 and 55 of the Draft Price Notification are provided showing 2012 pricing effects on ticket prices for Aircraft Type and Passenger Demand impact. These include 4 examples for the SAAB 340 (Rex aircraft) with 2 of the 4 being routes that Rex operates.

The impact on passenger charges including percentage increases on ticket prices, whilst showing what seems to be a modest increase, are based on a load factor of 100%. This is not an appropriate representation and a more correct basis would be that of 65%. The increased cost of services will not be spread by the airline based on achieving a consistent 100% load factor.

#### **4.5. Dynamic Efficiency**

*Performance measurement*

The ACCC is interested in stakeholder views regarding the appropriateness of the elements of the performance measurement system (i.e. key performance indicators, methodology and targets).

*Adoption of technology*

The ACCC seeks comment on whether:

- Airservices' adoption of technology is appropriate
- Airservices has adequate incentives to introduce more efficient processes or to invest in efficiency-increasing technologies over time
- Airservices' adoption of technology is appropriate in comparison to other air navigation and emergency services operators overseas.

The development and incorporation of KPI's by Airservices is welcomed by Rex.

Whilst it is accepted that these are developed under the heading "Services Charter" there are little, if any, KPI's identifiable that drive and measure internal economic efficiency gains.

It should also be noted that at the time of publication, many of the KPI's are under development including those relating to cost effectiveness (ATS Attributable or induced delays).