

# Regional Flights: Novel Ways To Share Broader Market Competition

*Please note this is not a completed document or set of ideas and there may be errors and also adjustments required. It however may be a good start in achieving a system to rectify the issues we see in the market.*

The flight cost issue is costing government via both the Patient Travel Scheme and for staff travel. Any % savings made from travel costs will lead to savings that can be instead put toward improved health outcomes and skilled employment for regional populations.

If there were a market-based solution to solve the cost of regional airfares that were sustainable in the face of large corporations, someone very likely would have done it.

There are a range of ideas in this document for potential solutions to the regional flight cost issue:

- Part one uses the broader market competition to place an upper limit on the regional airfare price for a particular route
- Part two uses a risk mitigation subsidy auction to lower the barriers for new competition to provide air and/or support services
- Part three has market based potential solutions, with most not being sustainably viable in the face of large corporations

## **Part I - 'Sharing Competition'**

There should be no doubt costs are higher on regional routes than on higher volume coastal routes. But is it because of profit or cost?

At least in Mt Isa, a proxy upper-limit to cost is suggested by the historical price of flights that are well in advance or on sale. It is unlikely in the current competition-scape that these sale prices would have routinely been below cost on a sub-market like Mt Isa. Therefore it would appear that competition is lacking at least for medium and near term flights based on what we have seen in the market before the political spotlight was turned on.

If there is a competition issue then in the absence of a sustainable market-based solution then there are three choices for Government:

1. Do nothing
2. Intend to fix it
3. Fix it

So can government via regulation bring competition to non-competitive sub-markets in a balanced way? I believe so in this case, however this is not just about the airlines.

There are a range of cost issues on some regional flights that mean flight costs are higher. Some of these are:

1. Regional airport charges, service provider charges, and others
2. Smaller aircraft with higher per seat costs on some routes
3. More % variability in booking levels over time and on some routes lower % booking rates<sup>1</sup>
4. A mechanism of failure of the market competition paradigm that current legislation does not address

Some suggestions:

1. Point 1: Expose local airport and other charges in airline customer invoices (itemised or grouped where reasonable) so customers can see who is charging what and for what service. For comparison include a summary of metropolitan airport (and other) charges for reference. This will not remove the underlying airport monopoly issue as airport charges are part of the problem. If people want I can have a think about potential ways to address that.
2. Point 2 & 3: This is likely best left for the airlines to titrate demand with seat availability and aircraft type
3. Point 4: Introduce a mechanism that shares broader market competition to flight routes where market competition is failing, and one that also has no effect when competition is working 'near enough' in line with the broader market

Point 3 involves a hybrid mechanism that fuses both market and regulatory elements that aims to introduce competition from the broader market into sub-markets where that competition has failed to materialise for whatever reason. It will only help if the broader market is more competitive than the sub-market.

The discussion here only centres on flights however it equally can be applied to regional airports.

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<sup>1</sup> Smaller populations on average represent higher % random and seasonable/event based demand volatilities and therefore needs higher availability per passenger (for booking freedom), or a reduction in service availability (for on average fuller, cheaper flights – whether savings are passed on in the second case is another matter).

It must be stated that more often than not regulatory intervention in a market is a second choice behind generally more efficient market based mechanisms unless the required action is not being achieved by market based mechanisms. If the suggestion below is to be used it should only be used for essential and near-essential products and services. It should not be extended beyond that as discretionary and luxury spending are just that. The use of this mechanism and how and when it is applied would perhaps be a matter for public debate.

Point 3 may be attained by the following:

1. Ascertain average cost per passenger-seat-kilometre over the total domestic market and separately for the sub-market. Having access to sales, costs, route and volume data will allow the calculation of the respective profits per passenger-seat-kilometre
2. To come up with an economy fare ceiling that has similar levels of profit to the broader market, add the sub-market per passenger-seat-kilometre cost to the broader market per passenger-seat-kilometre profit and then multiply by the number of kilometres. A price variance will be need to be added for quasi-quantifiable local issues that are not able to be accurately costed <sup>2</sup>, say 20% of the difference between per passenger-seat-kilometre costs for market and sub-market. Also a dynamic adjustment for fuel and other price-volatile costs
3. The system would need regular revision of costs and profit to keep them up to date and some form of audit and commercially relevant remedies for sustained/repeated breaches above the economy fare ceiling without reasonable justification

Care must be taken that cost factors introduced reflect true costs, and do not over-complicate the mechanism.

If ascent, level flight and descent per kilometre costs are drastically different then it wont matter as they are taken into account already as it is only the broader market profit that is applied to the local route fare ceiling and not the broader market costs. This mechanism clears up a lot of issues around cost comparisons and greatly simplifies the system.

There may a perceived issue with cost and profit data transparency as there may be commercially sensitive elements. However these sensitivities will likely be over-played and business passes many of these details to the ATO and civil aviation authorities anyway.

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<sup>2</sup> If the scheme does not support a measure of commercial viability then airlines will refuse to provide services. There is variability in costs over time such as fuel costs and so there needs to both be regular revision of the costs, and room to move in the interim.

## Part II – Risk Mitigation Subsidy Auctions

The airlines will be exceptionally hungry for a direct government subsidy like the big ones that are on our air routes north of Mt Isa. If the government is thinking about subsidies then perhaps it can look at ways it can use that subsidy to increase levels of competition and how to use that to minimise cost to government.

The idea with the risk mitigation subsidy auction is to lower the risk to new competition entering into a sub market, but allow anyone to bid and let the market determine the level of subsidy. Here's how I see it working, although its not a complete system yet as it needs more work but the submission deadline is near and may not be clear from my explanation of the ideas:

- Government offers an auction of an up front guaranteed per-passenger re-payable risk mitigation subsidy based on proven costs and expected passenger volumes
- Public auctions are held periodically, say monthly, six monthly, or annually. More auctions can be held on demand if the subsidy is repaid early due to higher than expected demand, or if there is only low volume acceptance of the subsidy at the prices submitted.
- Any compliant air service can bid down the subsidy per passenger and cover more or less passengers. The airline willing to take the lowest combination of risk mitigation subsidy total and subsidised passenger numbers wins the auction
- If it turns out to be needed, the Government sets a ceiling and a floor for the maximum and minimum number of passengers to be covered to prevent disruption to the mechanism (\$1 for 1 passenger bid by one of the current operators for example to disrupt the auction and stop competitors)
- The airline repays the subsidy for each passenger flown so if government runs its numbers then it can have all of the subsidy repaid or in effect offer a subsidy for a greater number of passengers to remove more risk for new competition
- Conditions are attached to the subsidy:
  - A commercially viable fare ceiling that applies to all economy seats on all flights for the airline that wins the auction for a particular route
  - The fare ceiling does not restrict an airline from dropping prices to compete with other airlines
  - Conditions around reasonable minimum service requirements
  - To encourage the winning airline to compete and not just collect subsidy:
    - 3<sup>rd</sup> party ticketing and marketing incentivised to generate volume and prevent

- Subsidised seats are deemed to be filled before non-subsidised ones so the subsidy is repaid as fast as possible
  - After a period of time a portion of subsidy from an auction must be repaid. The rate that this is set at will determine the dynamics of how motivated an airline will be to compete.
  - If an airline is seen to not be adding market competition then all subsidy must be repaid.
- To reduce capital barriers for new entrants into the market, for specified set-up costs to support a new entrant into a particular route, government backed loans are offered
- Auctions can be phased out by progressively reducing the maximum number of passengers covered and be titrated with the ebbs and flows of the local market competition.
- If a market is unable to sustain an extra competitor or competition again fails, then the Auctions can be reinstated at a level that supports that.

The existing airlines will want to stop new competition entering into and becoming established in 'their patch'. So depending on the fare ceiling, they may well bid to win the auction. If that is the case then they will have to abide by the rules and this will simulate higher levels of competition. If it is too low for them but there is still commercially relevant profit to be made then another airline may bid and win the auctions.

I need to think more on how this mechanism can be disrupted, distorted, corrupted and otherwise rendered impotent, and also if it can be improved upon.

### **Part III – Market Based Solutions**

I have not yet seen a 100% market based solution to this problem that can be sustained in the face of large corporates outside of another large airline entering the market.

The most sustainable operational model I see still requires government assistance to get off the ground and again it may not be enough for an operator to be able to sustain an extended localised price war should the large corporates chose to take that path.

Some potential market based solutions to try and avoid regulation:

- Purchase a plane/run an airline:
  - Not viable unless one is a big corporate or another airline; or is it viable?

- Large capital risk
  - Large airlines would easily sink a small local competitor by drawing cash flow from other areas to undercut the competitor until the competitor is insolvent
  - Would need long-term market loyalty to the new service unless it can sustainably compete with the existing airlines, or the entity starting the service being well-resourced to survive sustained attempts to undercut the new service
  - End of business based solutions. Enter broader market solutions: See local shareholder models. With government support to set this up it may be possible to make this work, become much like the credit unions/building societies are part of the banking landscape. This combination is the best hope I see so far for addressing the issue using a market-based model.
- Hire/ lease a plane +/-staff (e.g. Alliance airlines) with standard business model:
  - May not be viable except when filling temporary gaps in service
    - Additional margins for supplier means airlines that own their own planes may be able to routinely undercut the service that hires/leases a plane +/-staff due to a lower cost base (if faced with such competition, Qantas may switch back to using their own planes for this purpose, and may make it initially difficult for Alliance to signoff on the first service flight to another party, so another supplier may be needed)
    - Would need long-term market loyalty to the new service unless it can sustainably compete with the current airlines
    - Useful for continuation of service when growing capacity towards the next capital outlays
- Uber-style flights:
  - Not viable
    - Private planes are far less bountiful than private cars
    - Private pilot licences do not allow one to fly commercial flights
- 'Build demand & go' (this business model requires the passenger-dollars collected to be greater than the flight costs before a flight can occur, thereby minimising risk to the operator and costs can be brought down):
  - Potentially partially viable for a small portion of the market
    - If there are plenty of people buying into the service and flights fill quickly then people do not have to wait as the plane will fill to above threshold and the indicated flight time will in the majority of cases be the actual flight time. This will then fully threaten the airlines and they will do everything to break the model
    - As a result demand would likely drop and it could take some time before enough people sign up for a flight for it to leave so it is like being on standby but for days or weeks

- There is potential for the part of the market that has time-freedom to take this up.
  - Initial success depends on ticket price and this will determine how full a flight has to be which affects how long people may have to wait for a flight to occur. The model breaks if there is not good demand. If the waits are too long demand will be low due to inconvenience.
- 'Build demand & decide' this business model builds demand for a scheduled flight. If the number of passenger dollars is less than the flight costs then the flight is cancelled and if equal or greater then the flight proceeds. Requiring that the flight is paid for minimises risk to the operator and costs can be brought down:
  - Potentially viable for a part of the market
    - If a flight is cancelled and fares refunded, then people would have the option to pay very high prices with the other airlines for last minute flights, to not fly, or to be booked with the next scheduled flight. A portion of those on a cancelled flight will book for the next flight raising the chances that the next flight will occur
    - Model is unsuitable for people with connecting flights or appointments/deadlines
    - Again the model somewhat breaks when demand is low as flight times become too far apart as low demand generates inconvenience which leads to even lower demand
    - If flights are too far apart then this model can be hybridised with the prior one so instead of cancelling flights, they are delayed to a point and then if still not filled then cancelled/rolled over to the next flight
    - Customers will need to understand that flights may be delayed or cancelled and be given service statistics before they pay.
    - Whilst it might be acceptable for a new service to operate a service-disrupted model, it would be disappointing if existing airlines switched to a service-disrupted model to lower costs as quite a few people have time-critical needs and the absence of reliable services would be a major inconvenience to them. Jetstar tried a form of this service (flight consolidation etc.) in NZ in order to compete with lower pricing whilst maintaining a profit, and lost a heap of business over time. As a result they are more reliable again proving that the majority of people, after they have experienced inconvenience repeatedly, prefer reliable services over cheaper inconvenience-creating disrupted ones, because there are other costs to those that exceed the upfront cost of a reliable service.
    - Overall there may be a portion of the market willing to support a service-disrupted service but over time that number may not be large
- Local shareholder models

- Locals own an airline service through a non-profit (or profit making entity that 100% contributes to local benevolence projects). Government perhaps can assist with the set up (e.g. low interest loan and hiring expertise, and smoothing the path to compliance, safety etc. if hire-planes/hire-crew are not going to be used)
  - Each individual owns a share
  - If a local population expands, additional shares are issued
  - If a local population shrinks then the shares of people who no longer reside in the area become the property of the airline, to be re-issued if the population expands
  - Airline-held shares have no voting rights when held by the airline but rights are re-instated if re-issued to a person
  - Only people can own shares. No companies, trusts etc. although
  - Government and business may or may not own shares as 'proportional stakeholders' or some other
  - Public auditing to prevent corruption and fraud
  - Mechanism for longer term FIFO and locum workers to be included as they use the service regularly.
- Passengers buy time-based shares
  - Like Chrisco, passengers and pay instalments in advance and then fly when they want, only their voting rights grow as
  - Still thinking about this as there are a range of problems with this crowd-sourced pre-funded flight model
- Hybrid business-local shareholder model
  - Likewise. Many ways to do this. Many potential conflicts of interests. Much to experiment with.
- Autonomous drone cars (with hundreds of small propellers so failure of a few will not matter so they will be a lot safer than a helicopter):
  - Will be slower than a jet and require more fuel which like helicopters, may limit range. So likely way more efficient and free than short-haul flights, but time-wise for longer haul flights the jets and airports have the edge.
  - Requires technology and legal advances