

Regional Airlines

Cost Structure of Regional NSW Air Services

Prepared for

The NSW Air Transport Summit Working Party

By

The Western Research Institute

9th July 2001

What is the story on the regional airlines of NSW?

- Regional airlines in NSW are less profitable than domestic airlines.
- Government costs and charges impact, either directly or indirectly, on cost categories that account for 55% of the total costs of regional airlines.
- Assuming revenue does not change, regional airlines could achieve a profit of 5.8% if there were a 6% reduction in costs. A reduction of 11% in the government influenced cost categories would also achieve this profit goal.
- The cost reductions in government influenced cost categories required for *small* regional airlines to reach the benchmark level of profitability are much greater (around 14%).
- Achievement of the target pull-back in government influenced costs and charges will help to promote the profitability of regional airlines and help maintain air services for NSW towns with populations of less than 20,000.



What is the role of the Working Party?

- The NSW Air Transport Summit Working Party was formed to prepare a submission on the costs and other issues affecting the viability of regional airlines.
- The WRI was commissioned by the Department of State and Regional Development to assist the Working Party.
 - The WRI was commissioned to provide an analysis of the cost structure of regional air services.
 - Of particular interest was the identification of the proportion of the costs of regional airlines that are influenced by government at the Federal, State and Local levels.
 - This information on government influenced costs and charges will help the Working Party to identify and prioritise the measures and initiatives that could improve the viability of regional airlines in NSW.



How did the WRI conduct it's study?

- The WRI conducted a survey of regional airlines in NSW.
- The WRI Regional Airline Survey covered 3 *large* regional airlines and 3 *small* regional airlines that operate in NSW. This survey covered the results of 5 regional airlines from 1999-2000 and one airline from a previous year.
- The survey asked the airlines to provide cost data under the categories of labour, labour on-costs, fuel, maintenance and overhaul, Air Services Australia, landing and terminal charges, Civil Aviation Safety Authority (CASA) and other. Other is a residual that includes all costs that do not fit into the specified categories.
- The cost data was collected as a percentage of total revenue, converted to percent of total cost and aggregated into an unweighted average to protect the confidentiality of the respondents.
- The overall results of the survey are shown on Slide 16.

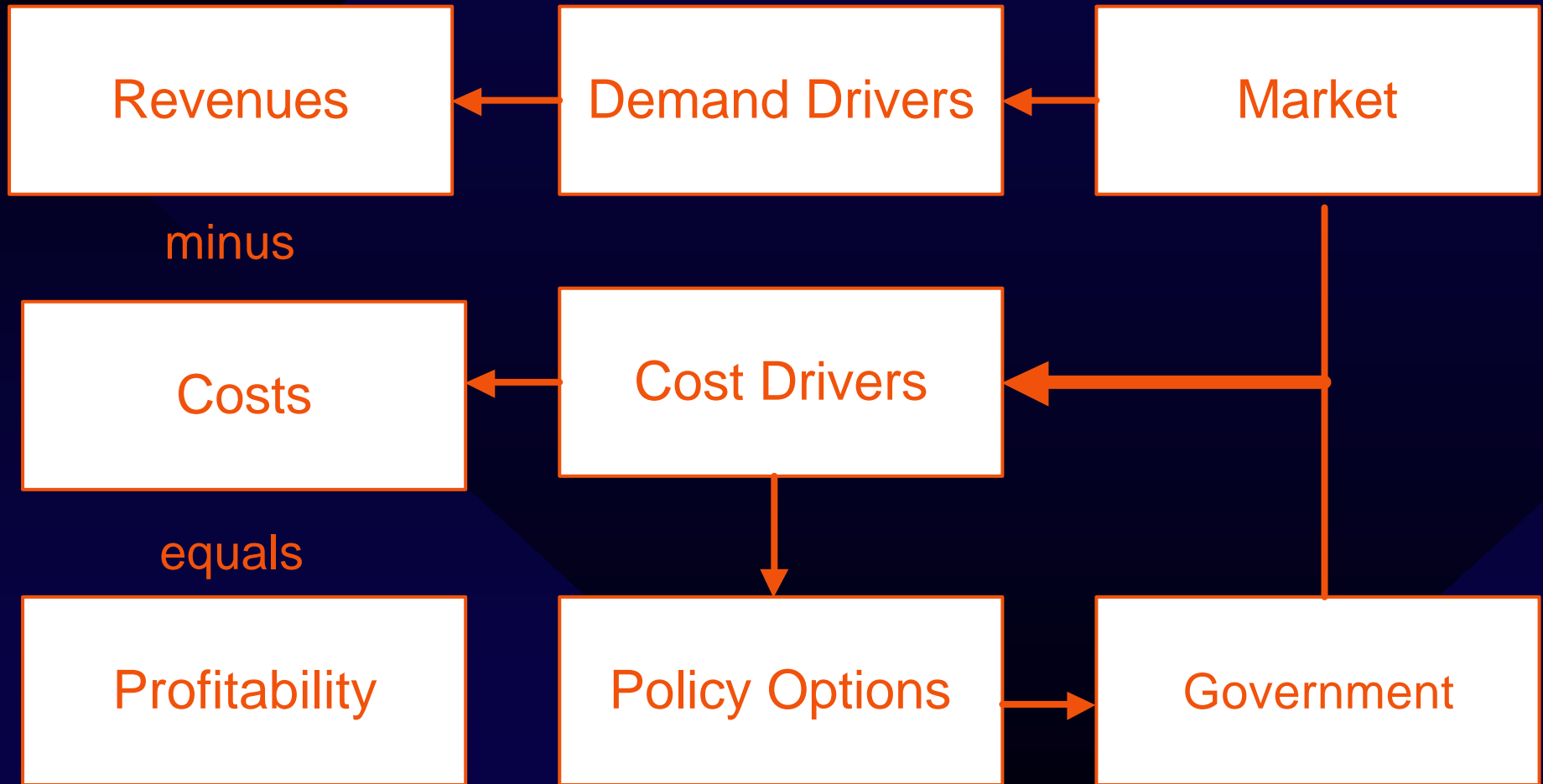


Are regional airlines viable?

- The continued viability of regional air services depends on the profitability of regional airlines.
- Profitability is influenced by revenue and cost factors.
- The demand drivers are those factors that determine the revenue of regional airlines.
- The majority of the demand drivers are market based leaving little scope for government policy action. However, demand drivers are partially influenced by government.
- Air service costs link directly to airline cost structures which are in turn linked to various cost drivers.
- A major concern of this study is the identification of those cost drivers that are either directly or indirectly influenced by government.
- If a significant proportion of air service costs are government influenced then scope may exist for government policy action to improve profitability and ensure long term viability of regional air services.



What is the link between profit and policy?



Are regional airlines profitable?

- One common measure of profitability is earnings before interest and tax (EBIT).
- The WRI Regional Airline Survey shows:
 - The average EBIT of a regional airline in NSW is 0.3% of revenue (standard deviation = 10.3%).
 - The average EBIT of *small* regional airlines is –2.9%.
 - The average EBIT of *large* regional airlines is 3.3%.
- Annual reports for Qantas and Ansett show an average EBIT for domestic airlines in Australia of 5.8% (standard deviation = 2.1%).
- These findings are consistent with the fact that many regional airlines are going out of business (i.e. Country Connection, Yanda, Flight West Airlines [QLD]).



Are regional airlines profitable? (Continued)

- The EBIT figures for regional airlines in NSW suggest:
 - Regional airlines in NSW are, on average, less profitable than domestic airlines.
 - *Small* regional airlines in NSW are, on average, less profitable than *large* regional airlines with at least some *small* regional airlines making a loss.
- Comparisons between *small* and *large* airlines are subject to qualifications:
 - The comparisons are based on the proportions of each cost item as a percentage of total costs. The comparisons do not indicate actual dollar value differences.
 - Some differences in costs may be due to different accounting methods (i.e. how costs are classified into the different categories by each regional airline).



Why are regional airlines becoming less profitable?

- The demand drivers impacting on revenue include:
 - Passenger demand for regional routes in NSW for the year ended 31 March 2001 increased overall by 6%.
 - However, there was considerable variation between routes (ranging from plus 33% to minus 31%). However, passenger demand declined on 8 of the 10 recently closed regional routes in NSW.
 - The price elasticity of demand for regional air travel is high, which limits the ability of regional airlines to increase prices to cover increasing costs.
 - Anecdotal evidence of this high demand elasticity over the long-term is provided by Yanda who argue in their submission that prices for regional air travel have fallen in real terms by as much as 30% in the past 15 years.
 - An industry contact suggested that government employees make up to 50% or more of regional airline passengers and tighter government budgets have constrained this important segment of the market.
 - Improvements in the road transport system are providing more cost effective substitutes on some regional routes in NSW.



Regional airlines becoming less profitable? (Continued)

- The major cost drivers influenced by the market are:
 - Increased fuel prices. The price of Avgas has increased by 80% in the period February 1999 and June 2001.
 - The low Australian Dollar, which has increased the cost of aircraft, parts and fuel.
 - A shortage of experienced pilots that has increased recruitment and training costs for regional airlines.
 - Reservation charges for services provided by the major airlines have increased.
 - The *small* regional airlines have a lack of market power that may affect the prices they pay for their inputs. For example, *small* regional airlines may not be able to purchase petrol or parts from large oil companies and parts manufacturers at the same price as domestic airlines and subsidiaries of the domestic airlines.
- Cost drivers that are government influenced can be either direct government costs and charges or indirect government costs (i.e. the compliance costs of government regulations).



What are the direct government influenced costs?

- The NSW Air Transport Summit Working Party has identified both direct and indirect government influenced costs and charges as potential targets for policy actions aimed at improving the profitability of regional airlines. Several direct costs can be identified.
- In July 1995 the Federal Government split the Civil Aviation Authority (CAA) into two separate government bodies, Air Services Australia (AA) and the Civil Aviation Safety Authority (CASA). Both government bodies levy charges on regional airlines in NSW.
- Air Services Australia has introduced location specific charges for low capacity regional airlines for terminal navigation, rescue and fire fighting and *en route* charges, in place of an excise levy on Avgas. Air Services Australia charges equal approximately 4.3% of total costs (Federal).
- The direct charges of the Civil Aviation Safety Authority (CASA) are relatively small (i.e. 0.3%) but the compliance costs associated with CASA regulations may represent significant indirect costs (Federal).



Direct government influenced costs? (Continued)

- The licence fee on regional air operations is equal to approximately 0.2% of total costs (State).
- Regional airlines are also subject to a range of taxes that are common to all businesses. These include the excise tax on fuel (Federal), payroll tax on wages (State) and fringe benefits tax (Federal).



What are the indirect costs of government regulations?

- A major indirect cost for regional airlines is argued to be the compliance costs associated with Civil Aviation Safety Authority (CASA) regulations.
- Examples of CASA compliance costs include:
 - Regional airlines must complete a compliance statement that shows how an operator will comply with CASA regulations. One industry contact stated that the preparation of this statement required a full working week.
 - Since the early 1990s the renewal of airline operating licences has taken place with increased frequency and with increasing cost.
 - CASA audits of the operations of regional airlines have a relatively greater compliance cost compared to domestic airlines.
 - CASA pressure to introduce new turbine engine aircraft.



Indirect costs of government regulations? (Continued)

- In 2001 the Federal Government amended Slot legislation for the Kingsford Smith Airport (KSA). This amendment encourages larger aircraft that will place cost demands on *small* regional operators.
- Other indirect government costs and charges that affect regional airlines, but are common to other businesses include:
 - Changes to regulations on such things as superannuation (Federal) and workers compensation (State) that add to labour on-costs.
 - Compliance costs associated with the new tax system (i.e. the GST) introduced by the Federal Government in July 2001.
 - Federal government changes to taxation rules on the depreciation of capital items have impacted adversely on regional operators when aircraft replacement is required.



What is the extent of government influenced costs in the regional airline industry?

- Government influenced costs and charges extend across many of the cost categories for the regional airline industry.
- The WRI Regional Airline Survey shows that government impacts, either directly or indirectly, on survey cost categories that account for 55% of total regional airline costs. The results of the WRI Regional Airline Survey are shown on Slide 16.
- Direct government influenced costs that are specific to regional airlines account for at least 11% of their total costs.
- These direct government influenced costs, in order from largest to smallest, include:
 - Landing and Terminal charges = 6.2% (primarily Federal and Local).
 - Air Services Australia charges = 4.3% (Federal).
 - CASA charges = 0.3% (Federal).
 - Licence Fees = 0.2% (State).



What is the cost structure of regional airlines?

Source: WRI Regional Airline Survey for 1999-2000

Cost Item	Percent of Total	Standard Deviation
# Maintenance/ Overhaul	22.9%	9.0%
# Fuel	17.7%	9.9%
Labour	16.2%	4.9%
* Landing/ Terminal Charges	6.2%	3.4%
# Labour On-Costs	5.8%	4.3%
* Air Services Australia	4.3%	3.3%
* CASA	0.3%	0.2%
* Licence Fee on RTP Operators	0.2%	0.0%
Other	26.4%	19.4%
Total	100.0%	0.0%

Note: * Direct government influenced cost categories
Indirect government influenced cost categories



Extent of government influenced costs in the regional airline industry? (Continued)

- The identification of the indirect component of costs, which can be attributed to government influence is problematic. The extent of these indirect costs may vary between different regional airlines depending on variables such as the type of aircraft used, their operations and their compliance systems.
- The majority of indirect costs relate to the compliance burdens associated with meeting CASA requirements. Although these cost burdens are embodied in maintenance and overhaul that account on average for 23% of total costs, it is not possible to separately identify all costs for which CASA is responsible. An accurate analysis of the cost burden caused by CASA would require identification of those costs that CASA regulation impose *in addition* to the expenditure that would have been made on maintaining equipment and safety standards in the absence of this regulatory authority.
- Generic costs associated with common taxes, charges and regulations that impact on all businesses, are also difficult to isolate in this brief study. It should be noted that whilst concessions can be directed to assist selected industries, such an approach would run contrary to the long term microeconomic reform policies that successive governments have pursued for several decades.



Are there differences between the cost structures of small and large regional airlines?

Source: WRI Regional Airline Survey for 1999-2000

Cost Item	Small	Large
# Maintenance/ Overhaul	25.5%	20.6%
# Fuel	27.1%	9.0%
Labour	19.4%	13.2%
* Landing/ Terminal Charges	6.1%	6.6%
# Labour On-Costs	6.4%	5.0%
* Air Services Australia	4.6%	3.8%
* CASA	0.3%	No Data
* Licence Fee on RTP Operators	0.2%	0.2%
Other	10.5%	41.5%
Total	100.0%	0.0%

Note: some of the differences in the data provided may be due to different accounting methods used to classify data by small and large regional airlines. Conclusions drawn from the table are qualified and should be used with caution.



Differences between the cost structures of small and large regional airlines? (Continued)

- Subject to the qualifications mentioned the WRI Regional Airline Survey suggests:
 - Fuel is a higher proportion of the total costs of *small* regional airlines (i.e. 200% higher).
 - Labour and labour on-costs are a higher proportion of the total costs of *small* regional airlines (i.e. 50% higher and 25% higher respectively).
 - Landing and terminal charges are a lesser proportion of the total costs of *small* regional airlines (i.e. 10% lower). Note this result is partly due to the fact that fuel, labour and labour on-costs are a larger proportion of the costs of *small* regional airlines. The result does not imply that *small* regional airlines pay lower landing and terminal charges. Indeed, on a per head basis, taking account of load factors landing and terminal charges can be expected to be higher for *small* regional airlines.
 - Other expenses are about 75% lower for *small* regional airlines.
- Overall, government influenced cost categories account for at least 50% more of the total costs of *small* regional airlines compared to *large* regional airlines.



What are the priorities?

1. The direct costs of CASA are relatively small (0.3% of total costs). Yet compliance with CASA regulations increase the maintenance and overhaul costs of the regional airlines, a category that accounts for 22.9% of the costs of regional airlines. It is therefore suggested that an in depth review of these costs be undertaken to ascertain the extent to which CASA is contributing unnecessarily to the costs of regional airlines. There may be more efficient procedures that could be implemented that still achieve CASA's current objectives.
2. Fuel accounts for 17.5% of the costs of regional airlines. Fuel as a proportion of total costs is also 200% higher for *small* regional airlines compared to *large* regional airlines. Thus, *small* regional airlines may be disadvantaged by the pricing policies of the major oil companies.



Priorities? (Continued)

3. Landing charges account for 6.2% of the costs of regional airlines. The determination of landing charges at both the Federal and Local level should be reviewed to reduce the extent to which the burden of landing charges falls disproportionately on regional airlines.
4. Labour on-costs account for 5.8% of the costs of regional airlines. Some components of on-costs could be reduced. These on-costs should be reviewed as some components of on-costs could potentially be reduced, particularly in instances where government regulation creates a specific disadvantage for regional airlines.
5. Air Service Australia charges account for 4.3% of the costs of regional airlines. These costs could be reviewed to reduce their impact on regional airlines. A structure of flat charges will normally disadvantage the smaller operators. Consideration could therefore be given to making the charges levied by Air Services Australia more progressive.



Who were the research team?

- **Tom Murphy**
 - CEO of the Western Research Institute.
 - BEc (Hon) (UNE), MSc (Economics) (Lancaster).
- **Professor John Hicks**
 - Dean of the Faculty of Commerce, Charles Sturt University.
 - BCom (Hon), DipEd, MA (Hon) (University of Melbourne), PhD (Massey University).
- **Associate Professor Greg Walker**
 - Head of the School of Marketing and Management, Charles Sturt University.
 - MCom, DipEd (UNSW), PhD (Macquarie).
- **Matthew Brooks**
 - Research Economist at the Western Research Institute.
 - BBus (Econ/Psych) (CSU), MEd (SocSc) (Hon) (Sydney).

