AUSTRALIAN SENATE
SELECT COMMITTEE ON THE
SCRUTINY OF NEW TAXES

Submission for the Inquiry into the Carbon Tax Pricing Mechanisms

by Regional Express Holdings Limited

August 2011

1. Background about Regional Express

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

1.2. Regional Express Holdings Limited was listed on the ASX in 2005. The subsidiaries of Regional Express Holdings Limited are:

- Regional Express Pty Limited (**Rex**), the largest independent regional airline in Australia;
- **Air Link** Pty Limited, which provides passenger charter services based out of Dubbo NSW,
- **Pel-Air** Aviation Pty Limited, whose operations cover specialist charter, defence, medivac and freight operations; and
- The Wagga Wagga (NSW) headquartered **Australian Airline Pilot Academy** Pty Limited (**AAPA**) which provides airline pilot training including training for the Rex cadet pilot programme. This is the only such cadet program operating in Australia today.

1.3. Despite the diverse nature of the Rex Group of companies, the core business undertaken by Rex is the provision of essential regional regular public transport air services. Rex operates on 33 routes throughout South Australia, Victoria, Tasmania, New South Wales and Far North Queensland. The Rex services provide a critical link between regional Australia and capital / major cities with Rex operations linking 29 regional destinations to Adelaide, Melbourne, Sydney and Townsville.

1.4. In Rex's start up year of FY02/03 Rex carried some 600,000 regional passengers however in the process it lost some $30M and was at risk of another collapse. In the most recent FY10/11 Rex carried some 1.2M passengers on practically the same route network that it had commenced operations with in FY02/03.

What is unique about this significant growth is that the average ticket price paid by Rex's customers over this 8 year period has increased by less than 1%, which in real terms represents a significant reduction being well below CPI over this 8 year period. It is even more significant when fuel increases of 100% since FY0203 are taken into account, which push the growth in real costs for an airline well above CPI. Typically fuel constitutes around 16% of a regional airline's operating costs.

1.5. Keeping regional air fares affordable has been the single most significant catalyst for the record regional passenger growth that has been delivered by Rex and this has enabled Rex to increase its flying activity, make flight schedules more frequent and convenient whilst at the same time improving the airlines efficiency through greater economies of scale.

1.6. Rex operates 51 Saab 340, 34 seat turbo-prop aircraft which makes it the largest Saab 340 operator in the world. The Saab 340 is the ideal aircraft for servicing thin regional routes.

1.7. Rex has been acknowledged as the best regional airline in the world in recent years

AVIATION WEEK
Top Performing Regional Airline
2011, 2010, 2009

ATW Air Transport World 2010
Regional Airline of the Year

CAPA Aviation Awards for Excellence
REGIONAL AIRLINE OF THE YEAR
2007, 2008, 2010

2. Why the Carbon Tax (CT) does not make sense for Regional Air Services

2.1 Change of Behaviour

One of the primary objectives of the Carbon Tax (CT) is to bring about a change of behaviour so that activities that emit more carbon are replaced by activities that emit less carbon. In the regional airline context this is not possible and in fact may achieve the opposite effect:

- The main competitor and option to regional air services is the car. General motorists will not be subject to the CT through increased fuel price and this will have the effect of encouraging some passengers to drive as the CT makes it more expensive to fly. Typically a Rex flight is 40% less polluting than the car and therefore the CT in its intended form will have the perverse effect of increasing pollution.

- Regional airlines have no ability to substantially reduce their carbon footprint, outside of reducing activity, as the turbo props typically used are the most fuel efficient aircraft available (cost of fuel comprises 16% of total cost compared to 30% for jet operators) and the high cost of fuel has already driven regional operators to ruthlessly reduce their fuel consumption wherever possible and to achieve maximum efficiency. Adding the CT will not result in less carbon emission per kilometre.

2.2 Essential Services

Regional air services provide essential services to the regional communities that rely on them for commuting to/from the capital cities to obtain medical, educational and professional services. The only thing that the CT will achieve in this respect is fewer people who want to live in the regional areas contrary to many Government policy initiatives. The Government has promised special relief for organisations like the RFDS and the same consideration should be given to regional air services because of the essential services it provide.

2.3 Unequal Burden

Fuel for international flights is not subject to the CT (imposed via the fuel excise) yet they are among the largest aviation polluters. There is no reason why the CT should not be imposed on all flights including international flights as foreign flag carriers also pick up fuel in Australia. In Europe all international flights are subject to a carbon penalty through the European ETS.

2.4 Slew of Additional Taxes/Costs on Regional Airlines

Regional airlines are traditionally a marginal economic activity and in Australia 8 regional airlines have collapsed in the last 8 years with no new entrants. From 1 July 2012 regional airlines will be faced with a whole host of additional taxes/cost increases that will severely threaten their very survival and/or the many regional routes that they operate on. Specifically:

- Carbon Tax (through increased fuel excise)
- Removal of the En-route Rebate Scheme
- Fuel excise increases (originally implemented in FY10/11 but budgeted to increase further in the coming FYs) to provide additional CASA funding. It should be noted that International airline operations, Airservices Australia and capital city airports are exempt from this fuel excise despite the fact that they also utilise significant CASA resources.
- Additional security screening measures and subsequent operating costs increases at regional airports. These measures will cost the regional airlines almost $1 million additional every year in <u>each</u> port where they are mandated.
- Other significant cost increases that relate to CASA mandating expensive new technology requirements for regional aircraft (see attached 6 threats to regional aviation)

The combined effect of all the above is estimated to be well above $6 million a year for Rex. To appreciate the magnitude of this imposition, the $6 million is equivalent to an additional burden of $420 million a year for Qantas whose latest reported profit after tax was less than $200 million.

3. The impact on Regional aviation

We foresee that the combined effect of the CT and all the other charges listed above will be that many regional airlines will go out of business within 24 months from 1 July 2012. The remaining airlines will have to shed marginal routes and shrink considerably in size leading to a loss of economies of scale and further inefficiencies. In the attached article we see a similar phenomenon happening in the USA where regional cities are also losing their services due to unbearable rising costs.

Rex has placed on record that there are 7 marginal regional ports (Sydney to Bathurst, Moruya, Taree, Grafton & Melbourne to Griffith, King Island and Merimbula) that could be cut or scaled back considerably if all the above taxes / additional costs eventuate potentially leaving these communities without a regular public transport air service.

4. Conclusion

Rex supports meaningful measures that preserve the environment. However in the case of regional aviation the Carbon Tax combined with the new slew of prohibitive measures will only result in a severe contraction of regional air services in Australia with the resulting economic and social devastation to the regional communities, through the loss of access to medical, business, educational, government and social services.

It will also have the opposite effect to that intended by the Government in that carbon emissions will be increased by passengers abandoning air travel for the car which is 40% more polluting per kilometer travelled.

The Government is well advised to weigh carefully the ramifications of its decisions with regards to regional aviation as the process once implemented may very likely be irreversible. Given the very challenging aviation environment today, once a regional airline collapses it is highly unlikely a new operator will replace it.

Attachments

1. 6 Threats to Regional Aviation

2. Article on loss of regional air services in USA – “24 Small Towns May Lose Air Services” (*The New York Times*)

ATTACHMENT 1

6 Threats to Regional Aviation

- Carbon Tax
- En Route Scheme
- ACCC Scrutiny of SACL
- Security Screening
- CASA Funding
- CASA Proposal on New Technology

6 Threats to Regional Aviation

Carbon Tax

Carbon Tax

Additional cost burden

- Air services will be taxed
- Carbon Tax proposed to be $23 per mt CO_2 equiv
- Rex consumption approx 115,000 mt CO_2 pa
- No shielding for regional air services
- Regional air services should be shielded at 100%

6 Threats to Regional Aviation

En Route Scheme

En Route Scheme

Background

- ✈ Introduced after Ansett Collapse as the only form of assistance to regional aviation
- ✈ Rebate of En-Route navigation charges for regional air services with aircraft < 15t
- ✈ Extended in FY08 for 4 years
- ✈ Annual cost of $6m miniscule compared to overall infrastructure spend of $12.5b (FY11)

En Route Scheme

Current Situation

- Abandoned in FY09 budget with rebate ceasing in 2012
- New routes and additional flights not covered since announcement
- Most regional routes to stop receiving rebate from 1 July 2010 but no confirmation so far

En Route Scheme

Consequences of termination

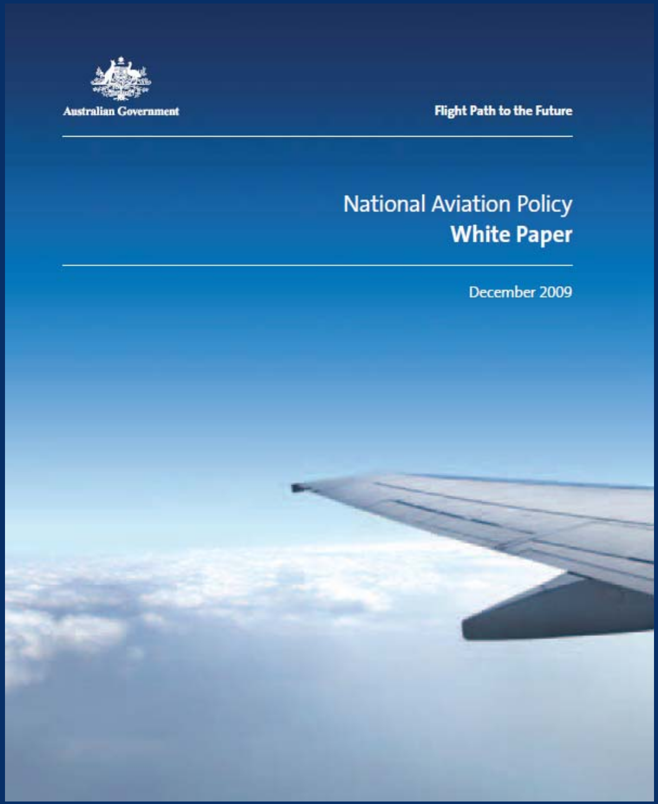
- Regional air services will decline at a faster pace
- Air Link exited *Mudgee, Cobar, Bourke, Lightning Ridge, Walgett and Coonamble* following announcement of cessation of the Scheme
- Rex thin routes potentially affected once rebates stops: *Taree, Grafton, Melbourne/Griffith, Bathurst, Moruya, King Island and Merimbula*

En Route Scheme

Decline of Regional Air Services

"Recent Bureau of Infrastructure, Transport and Regional Economics (BITRE) research has found that over the period 1984 to 2008 the number of regional airports served by scheduled airlines fell from 278 to 138, with the steepest decline on low density routes.19 The number of airlines serving regional airports fell from 53 to 27. There has also been a high attrition rate and turnover in the industry"

- Aviation White Paper Dec 2009



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PEL-AIR
AIR LINK
AAPA

6 Threats to Regional Aviation

ACCC Scrutiny of SACL

ACCC Scrutiny of SACL

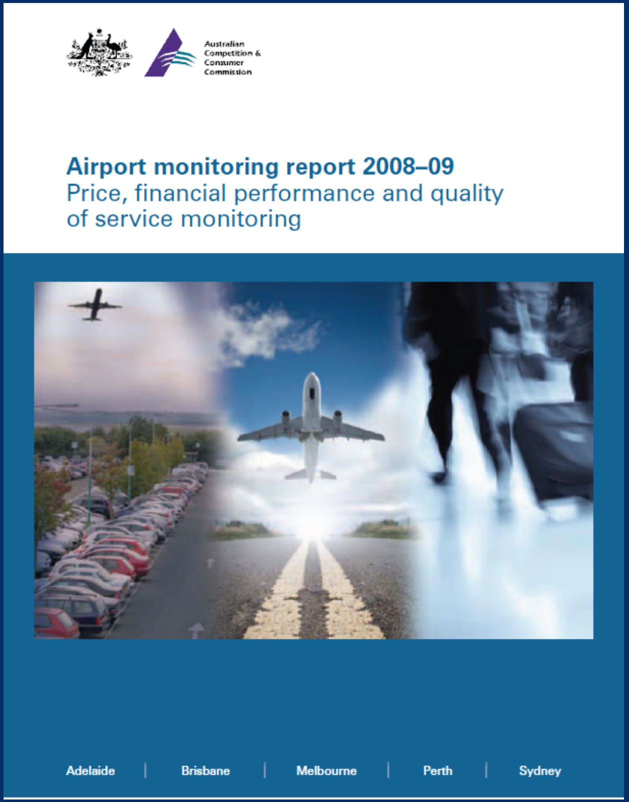
SACL's Behaviour

"The monitoring results indicate that Sydney Airport might be earning monopoly rents from aeronautical services"

- ACCC Report published March 2010

"As a result of this ACCC report I have asked the commission to bring that forward to as soon as possible," Mr Albanese said, adding it would it now be some time this year

- Albanese commenting in SMH on Productivity Commission report due 2012



ACCC Scrutiny of SACL

Failure of light-handed regime

- SACL consistently increases charges excessively for regional air services (e.g: hangar rents)
- ACCC ruled recent price rise attempts unjustified
- SACL illegally tried to unilaterally impose charges on regional aviation – stopped by appeal to ACCC.
- SACL Profits & charges continue to rise even when industry revenue dropped during GFC

ACCC Scrutiny of SACL

Productivity Commission

- SACL margins are excessive (>80% EBITDA last 5 years)
- Moved from world's 34th most expensive airport to 9th most expensive airport from 2000 to 2010

  - Giovanni Bisignani, Director General IATA, Aug 2010
- ACCC Inquiry gives regulators the ability to force SACL to open its books on pricing mechanisms.
- Re-regulation of SACL charges is needed to protect regional access to Sydney Airport.

6 Threats to Regional Aviation

Security Screening

Security Screening

Current Rules

- Required for aircraft above 30t (E170)
- From 1 July 2012 for aircraft above 20t (Q400)
- Not required for SAAB 340 unless within legislated 30 minute window
- Regional passengers still pay for security at airports where facilities are shared with large aircraft

rex. Regional Express PEL-AIR AIR LINK AAPA

Security Screening

Cost of Security

- Infrastructure costs between $1m and $5m
- Capital and running costs add $20 to $30 to the airfare for regional ports
- Double this for thin routes making them unviable
- Regional aircraft already have hardened cockpit doors to prevent hijacking
- Security screening should be risk based

6 Threats to Regional Aviation

CASA Funding

CASA Funding

Forward Estimates

Australian Government
Civil Aviation Safety Authority

- ✈ Fuel excise funding for CASA to increase from $80m to $124m over 4 years ($44m increase)

Civil Aviation Safety Authority

Appendix 3.2.1: Total budgeted revenue

	2009-10 $'000	2010-11 $'000	20111-12 $'000	2012-13 $'000	2013-14 $'000
Ordinary Appropriation from Government	50 125	42 779	42 757	42 784	42 816
Special Appropriation	79 768	104 646	110 191	116 072	124 447
Appropriations from Government	129 893	147 425	152 948	158 856	167 263
Regulatory service fees	12 000	15 000	15 000	15 000	15 000
Other cost recovery and purchase provider arrangements	7 231	2 537	3 084	2 383	3 084
Interest	2 225	1 871	1 986	2 100	2 100
Other	955	800	800	800	800
Revenue from other sources	22 411	20 208	20 870	20 283	20 984
Total revenue	**152 304**	**167 633**	**173 818**	**179 139**	**188 247**

- ✈ Proportion funded by fuel levy to increase from 61% to 74% in this period

rex. Regional Express · PEL-AIR · AIR LINK · AAPA

CASA Funding

Unfair Burden

- Int'l Flights and major airports do not pay although consuming considerable CASA resources
- Regionals are paying disproportionately
- Increase to Rex alone was $300k p.a.
- RAAA member airlines an extra $2.8m p.a.
- Funding of Regulators should be provided out of consolidated revenue and not by industry as with the Office of Transport Security, state rail authorities and the ACCC etc

6 Threats to Regional Aviation

CASA Proposal on New Technology

CASA Proposal on New Technology

CASA Discussion Paper

- Ignored industry/Airservices official consultation process through ASTRA
- Mandates expensive new technology in older regional aircraft
- Prohibitive cost (Rex SAAB fleet >$12m)
- Not practical for all older aircraft (Rex may be forced to retire 19 seat Metros) & may result in the closure of some regional airlines

CASA Proposal on New Technology

No cost/safety benefit case

- Some technologies have a benefit for regional aircraft (e.g: approaches with vertical guidance, ADSB OUT)
- The most expensive have little or no benefit (e.g: Dual GPS receivers, new collision avoidance sys.)
- Due process needs to be followed to get the most cost effective solution without crippling the industry or closing down some operators

6 Threats to Regional Aviation

END

ATTACHMENT 2

24 Small Towns May Lose Air Service

Robert Rausch for The New York Times

Delta Air Lines wants to cease its two flights a day serving Muscle Shoals, a town of 13,000 in Alabama.

By JOE SHARKEY

Published: July 18, 2011

Rural America, already struggling to recover from the recession and the flight of its young people, is about to take another blow: the loss of its airline service.

Delta Plans Service Cuts

Delta Air Lines plans to eliminate flights to 24 small airports in the Midwest and South. Although Delta receives federal subsidies for service to 16 of the affected cities, the airline says it cannot afford to continue flying to them.

Airports facing service cuts

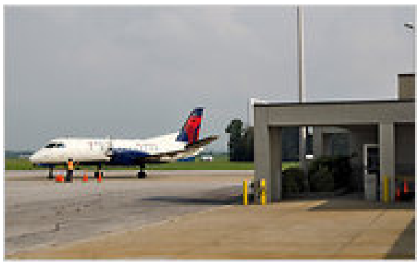
- Nonsubsidized
- Federally subsidized

Source: Delta Air Lines

That was underscored last week when Delta Air Lines announced that it "can no longer afford" to continue service at 24 small airports. The carrier says it is losing a total of $14 million a year on flights from places like Thief River Falls, a city of 8,600 in northwest Minnesota that fills only 12 percent of the seats, or Pierre, the capital of South Dakota, where Delta's two daily flights are on average less than half full.

Nationally, all major airlines have been reducing and sometimes eliminating flights altogether in small cities, as the industry concentrates much of its service in 29 major hubs, which now account for 70 percent of all passenger traffic, according to the Federal Aviation Administration.

Delta's announcement was especially acute because the airline operates in most of the small airports that receive a total of almost $200 million in federal subsidies to maintain air service under the Essential Air Service program. The subsidies are



scheduled to expire in 2013 unless revived by Congress. Delta acquired many of those small-city markets in the Midwest when it merged with Northwest Airlines.

Robert Rausch for The New York Times

Two Delta flights a day from the airport in Muscle Shoals, Ala., are backed by about $1.7 million a year in federal subsidies.

Airlines say that simple economics are driving them out of small-town America. With fuel prices high, carriers have been reducing domestic routes and seating capacity to focus on the flights that bring in the most revenue per plane — typically those in larger cities, especially major hubs. At the same time, airlines are removing less fuel-efficient aircraft from their fleets, including the 50-seat regional jets that have been the backbone of air service in small- and midsize markets.

"We just don't have airplanes that can serve small communities economically anymore," said Michael Boyd, the president of the air-service consulting firm Boyd Group International. "And unless somebody wants to pay a whole lot of money to carry a few people out of the airport at Thief River Falls, it just ain't going to happen anymore for a lot of those places."

One of those places, it appears, is Muscle Shoals, a town of about 13,000 along the Tennessee River in northwest Alabama. About $1.7 million a year in federal subsidies maintains two Delta flights a day from Northwest Alabama Regional Airport in Muscle Shoals, one of the 24 airports Delta wants to stop serving unless it can receive larger subsidies. Those flights are operated under the Delta name on Saab A340 turboprops flown by Mesaba Airlines, a Delta subcontractor.

Barry Auchly, of the Shoals Chamber of Commerce, said that the airport has enough market vitality to justify keeping commercial service. However, he said, passengers have fallen off since Delta decided this summer to redirect its two daily departures to Memphis, rather than to Delta's global hub in Atlanta where the flights went last year.

Delta says its flights from the airport are an average of 35.7 percent full, which compares with the national average on Delta's domestic flights of 81.9 percent in June.

“Last year, the first year with the Atlanta service, we exceeded 8,500 passengers and were well on our way to 10,000,” said Mr. Auchly. That growth proved, he said, that the local airport could eventually operate without federal air-service subsidies. He said Delta told him the destinations were switched because Memphis, though far less in demand, had more efficient turboprop service facilities than Atlanta.

“We want to be a self-sustaining airport,” Mr. Auchly said. “We think we have the demand; we just need to be able to depend on consistent service.”

Delta would like to continue flying from some of the 24 airports it designated last Friday as “underperforming” — but only if the federal subsidies were increased to cover the additional costs of serving them with regional jets. Meanwhile, Delta said it plans to abandon other airports where load factors were deemed too low, and assist those airports in finding replacement carriers.

Replacing a 34-seat turboprop plane with a 50-seat regional jet would seem to be counterintuitive in markets where the problem is too few passengers. Kristin Baur, a Delta spokeswoman, acknowledged that 50-seat regional jets, besides having 16 more seats, also are less fuel-efficient.

However, she said, regional jets are more popular with passengers, and can increase overall bookings in some markets where people will drive to more distant airports rather than fly a turboprop from the local airport.

Officials at some of the 24 small airports slated to lose Delta service said the airline has not flatly told them when it is stopping the flights, though at subsidized airports Delta said it would withdraw when the current contracts expired.

In some markets, depending on load factors, Delta would like to either receive new Essential Air Service contracts or get more money for the ones it currently has. Slightly more than a third of the airports Delta identified on its list would be in that group, it said.

Pierre, a scrappy city of 14,000 that sits smack in the rural center of South Dakota, got the news that it might lose Delta service just as weary residents were hauling away the last soggy sandbags as they recovered from major flooding of the Missouri River in May.

After years of receiving federal air-service subsidies, the airport now has four unsubsidized departures a day — two by the Delta subcontractor Mesaba and two by the regional carrier Great Lakes Airlines.

The city was recently so optimistic about its prospects that it began construction on a $12 million passenger terminal at Pierre Regional Airport.

“We’re rural America,” said Laurie Gill, the mayor. “It’s hard for me to understand a business decision to eliminate commercial air service based on the growth that we’ve seen here.”

Delta flew 4,840 of the total 6,833 passengers who boarded flights at Pierre this year through June, and Delta’s planes left with 47.4 percent of the seats filled on average. If Delta leaves and no other airline comes in, most travelers from the South Dakota capital would have to drive to the closest bigger airport in Rapid City, 140 miles away. Time-constrained corporate and government travelers dislike that idea, Ms. Gill said.

Welcome to the tough new world of commercial air travel, said Mr. Boyd, who thinks the Essential Air Service program serves a vital need for those communities that are far from an alternate airport with better service.

“It’s not like people are going to get cut off from the world. You may be able to have your local air service, but maybe it’s an hour’s drive away,” he said.

For example, Muskegon, in western Michigan, has a few daily flights operated by United Airlines, subsidized with $600,000 a year from the Essential Air Service program. Meanwhile, the Gerald R. Ford International Airport in Grand Rapids, 40 miles away, had two million passengers last year, and is served by eight airlines.

The savings from the short drive can be substantial. On Monday, for example, the lowest round-trip fare on a United flight to Kennedy Airport in New York from Muskegon, connecting through Chicago, was listed at $1,149. Drive to Grand Rapids, though, and you could find a flight to Kennedy for as little as $600 on various airlines.

“Muskegon has great air service,” Mr. Boyd said. “It’s called Grand Rapids.”

A version of this article appeared in print on July 19, 2011, on page B1 of the New York edition with the headline: 24 Small Towns May Lose Air Service.