Report on Air Services to and Tourism in Norfolk Island

etm travel consulting

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Contents Page

1 Introduction

- The purpose of this report is to consider:
  - The profitability and likely future profitability of Norfolk Air
  - Factors that might improve or decrease the profitability of Norfolk Air
  - Given that that a key determinant of profitability is tourist numbers, the likely outlook for and determinants of tourist numbers on Norfolk Island

- The majority of the work on this project, and the major item delivered, is the accompanying Excel-based model, described in the next section. This report is an accompaniment to the model, explains its use, and delivers and comments upon the outcomes of the model. The model is also meant for your continued use.

2 Methodology and The Accompanying Model

- A large amount of data is protected and locked in spreadsheet, with scenario inputs in open green cells. If at any stage any of the background data needs to be changed, I would be happy to assist.
- Please refer to the accompanying spreadsheet. It has nine sheets.
- **Sheet "1 Results & Scenario Inputs"** is the only sheet you would need to use for most purposes. It shows profit and average fare outcomes based on the inputs per route and overall. In cell F2 at the top, the model is set to historic "status quo" inputs unless you insert the letter X in this cell. Then the outcomes are determined by the scenario inputs that you make in this sheet.
- Passenger revenue is also calculated on the first sheet.
- Throughout the spreadsheet, open cells are green, all other cells are locked for the protection of formulae. Blue cells are outcomes. The password for each sheet and the entire workbook is "altamont".
- Beneath the scenario input sections are static charts. The charts in the spreadsheet are also provided in this report.
- **Sheet "2 Input Pricing"** is where current fares and other fees and charges are input, per fare type per route. Various assumptions regarding the rate of occurrence of ancillary charges are made in the middle section. Since data for ancillary charges was not available, reasonable, conservative assumptions are made. These can be altered. Total travel revenues per passenger per route per fare type are calculated at the bottom of this sheet.

- On Sheet **"3 Input Volumes"**, monthly passenger numbers per route per fare type from May 2008 are input, with charts appearing beneath the input tables.
- Cost breakdowns as provided by the airline are provided on Sheet **"4 Input Costs"**; both 2009/2010 actuals, and projected costs from the 2010/2011 budget. To the right of the basic cost inputs there is a provision to select a basis for automatic adjustment of each cost according to scenario inputs, and the ability to arbitrarily change any cost at the far right. Charts are beneath the table.
- The airline's current schedule of flights appears on Sheet **"5 Schedule"** for information only.
- The purpose of Sheet "**6 Price Comparison"** is to compare fares to Norfolk Island to those of a large sample of competing tourist destinations, grouped geographically. For each competitive route, the four cheapest different fares were obtained from the kayak internet metasearch site that searches a very large number of other booking sites. It is the best tool for obtaining available fare quotes from a range of destinations. A date one month in advance was chosen, and a three day window allowed around departure and return dates. The average of the four cheapest fares was calculated for each route. The cheapest fares on the Australia-Norfolk Island routes was obtained on the same basis. Average fares per kilometre per route are also calculated. The results appear in the charts beneath the table, placing the Norfolk Island routes in terms of fare and fare per kilometre against other routes for easy visual comparison.
- Sheet **"7 Price Sensitivity"** looks at seats sold per fare type per route, to gain an approximate measure of the price sensitivity of passengers per route. The results are calculated in the table and appear in the chart beneath it.
- The freight data, showing charges and monthly volumes per freight type as provided by the airline appear in **Sheet "8 Freight Totals"**. Revenue from freight is also calculated on this sheet.
- Sheet **"9 Tourism Data"** provides the monthly inbound tourist and public bednight data, with charts beneath the tables.

- The scenario function on Sheet 1 of the spreadsheet model has been used to test airline profitability under various conditions. These appear below in Section "8 Norfolk Air Profitability".

- The model and all analysis are based on return passenger numbers and fare levels.

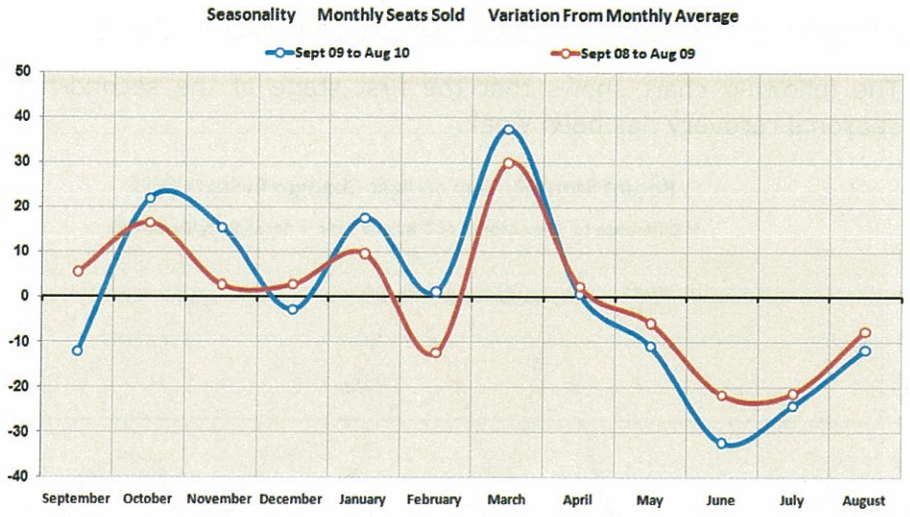
3 Interpretation of Passenger Volume Data

Main Points

- After recovering from the severe post GFC decline, passenger numbers commenced a second de-seasonalised decline in early 2010.
- It does not seem that this second bout of deterioration is GFC related.
- The cause of the second decline is not any known event. The weak subsequent recovery suggests that it may be longer-term in nature and have further to run.

Chart 1: Seasonality

- In the following chart, the overlay of two sets of recent annual monthly passenger figures (in terms of percentage difference to the monthly average) confirms a strong seasonal pattern.



- Passenger numbers peak in March, and then decline until June.

Chart 2: Monthly Seats Sold Since Before the GFC

- The text boxes on the following chart interpret the monthly numbers.
- Passenger numbers did recover from the GFC. However the subsequent seasonal decline in the months leading through winter in 2010 was worse than that fn the previous year.

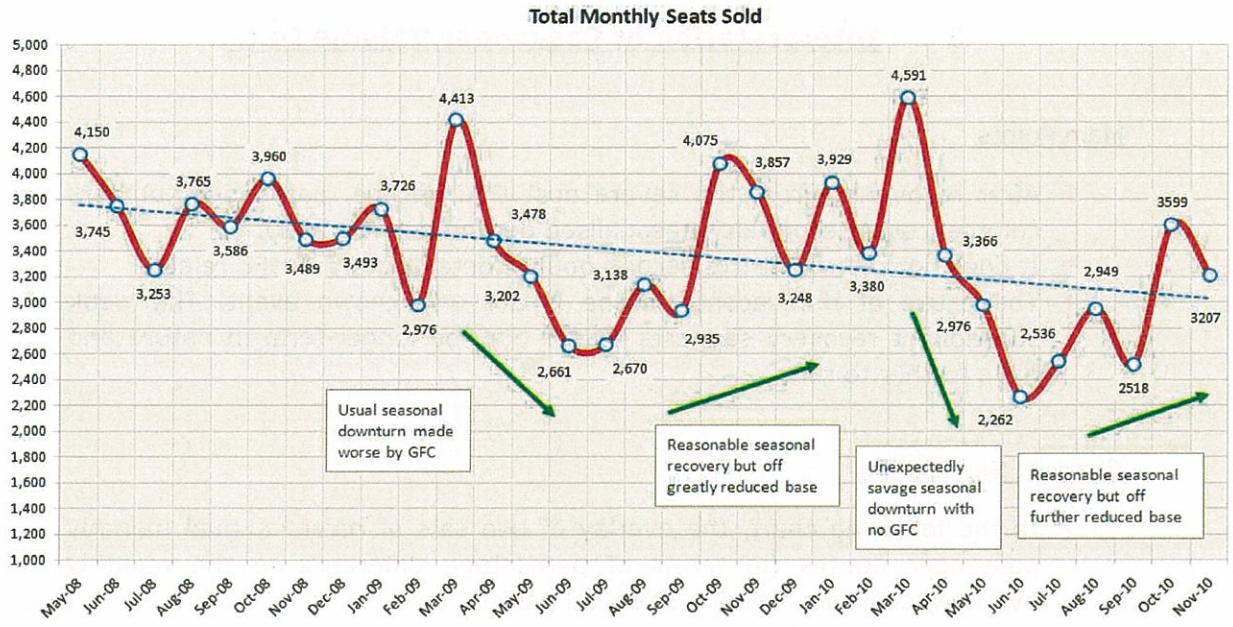
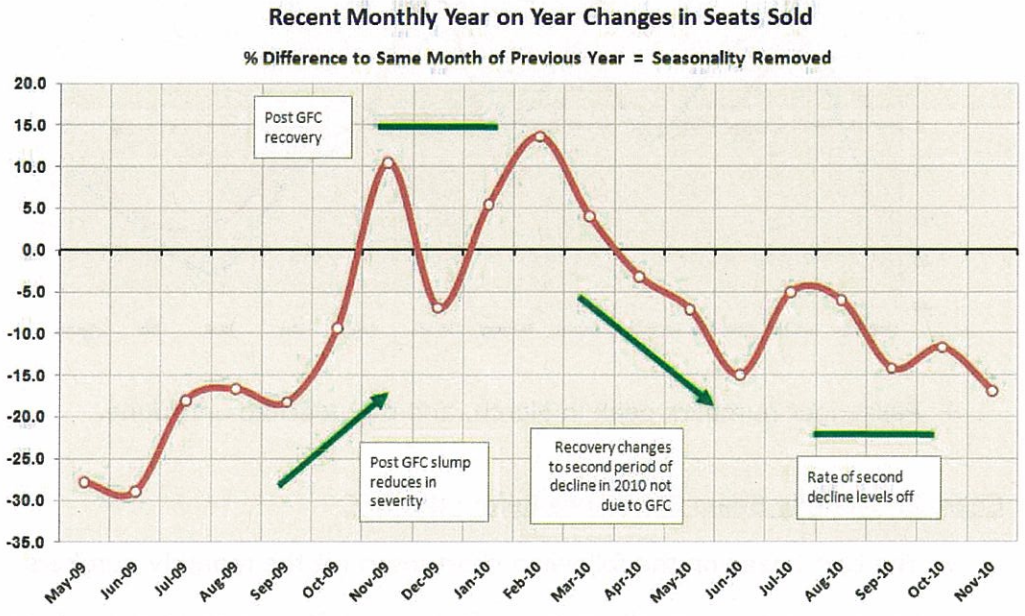


Chart 3 Monthly Year-on-Year Changes Show de-Seasonalised Trend

- The following chart shows that the first stage of the second-half 2010 seasonal recovery has been weak.

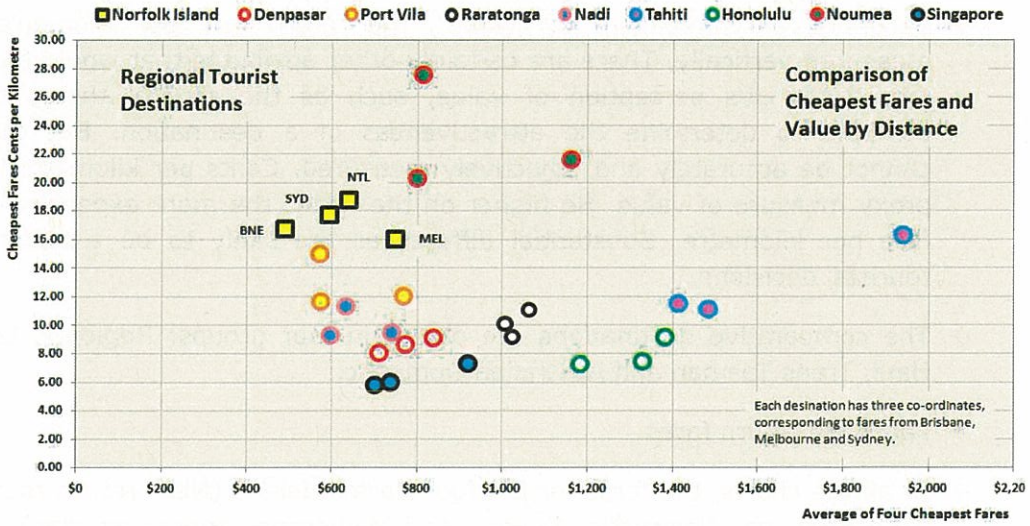


- This suggests that new negative forces have been at play since early 2010, worsening the mid-year seasonal decline, and weakening the seasonal recovery.

4 Fare Comparison With Other Destinations

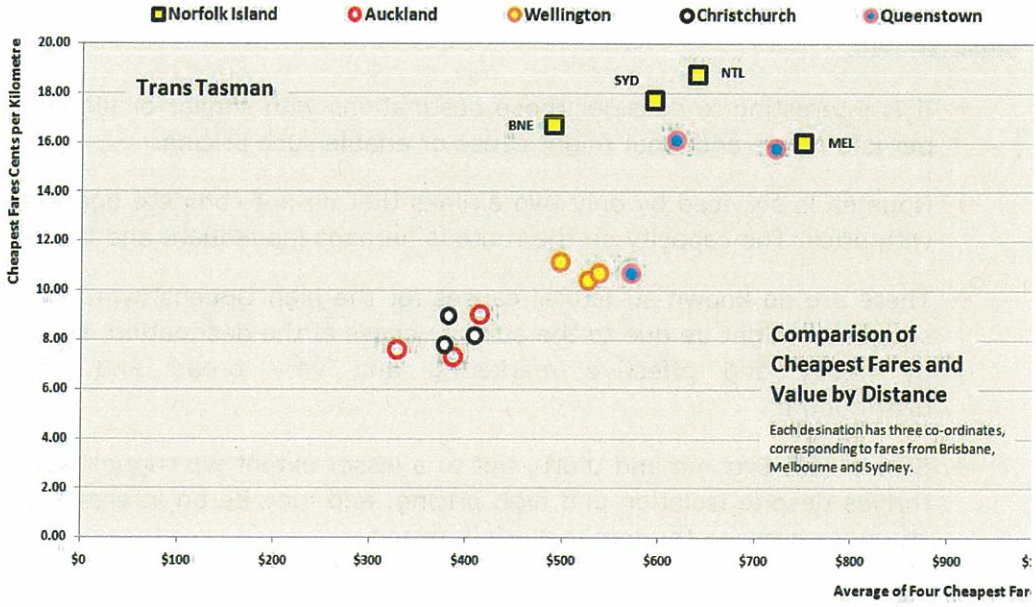
- An important consideration is the extent to which the airline could increase fare levels without decreasing demand such that revenue would increase.
- The much larger, and much more variable component of passenger traffic is that of tourists. It therefore makes sense to compare fares to Norfolk Island from Australian ports to those to competing tourist destinations.
- We have chosen a broad sample of destinations, as shown in the following charts.
- The methodology was to acquire the cheapest available public fares one month out, with flexible three day departure and arrival travel windows, as might be the case with a typical tourist.
- For the non-Norfolk destinations, the four cheapest different fares were averaged for each route. Three routes were chosen for each destination, with return fares from Brisbane, Melbourne and Sydney being included.
- Two measures can be applied to the charts.
- Firstly, the simple total cost of travelling to and from Norfolk and other destinations can be seen by their horizontal position. The further to the right, the more expensive the fare.
- Secondly, as a measure of "value", the return fare per kilometre is measured vertically. There are certainly other attributes that would factor into a tourist's perception of value, such as the several things that combine to determine the attractiveness of a destination. But these cannot be accurately and objectively measured. Cents per kilometre is a proxy measure of value. He higher on the chart, the more expensive the fare per kilometre. Substantial differences are likely to be a factor in tourists' decisions.
- The comparative destinations are placed in four groups: Regional, Long Haul, Trans Tasman and Australian Domestic.
- Fares are return fares.
- In all the charts, the fares for the four Norfolk Island (NLK) return routes, from Brisbane, Newcastle, Sydney and Melbourne, appear as black and yellow squares. Other destinations are also colour coded, as described above each chart.
- Firstly, we look at Norfolk Island compared to all other sample destinations.

- The NLK fares are more expensive than most Australian domestic ports, more expensive than Auckland and Christchurch but similar to Wellington and Queenstown, less expensive than most regional alternatives, and obviously much less expensive than the long haul fares.
- However, on a per kilometre basis, they are among the most expensive.

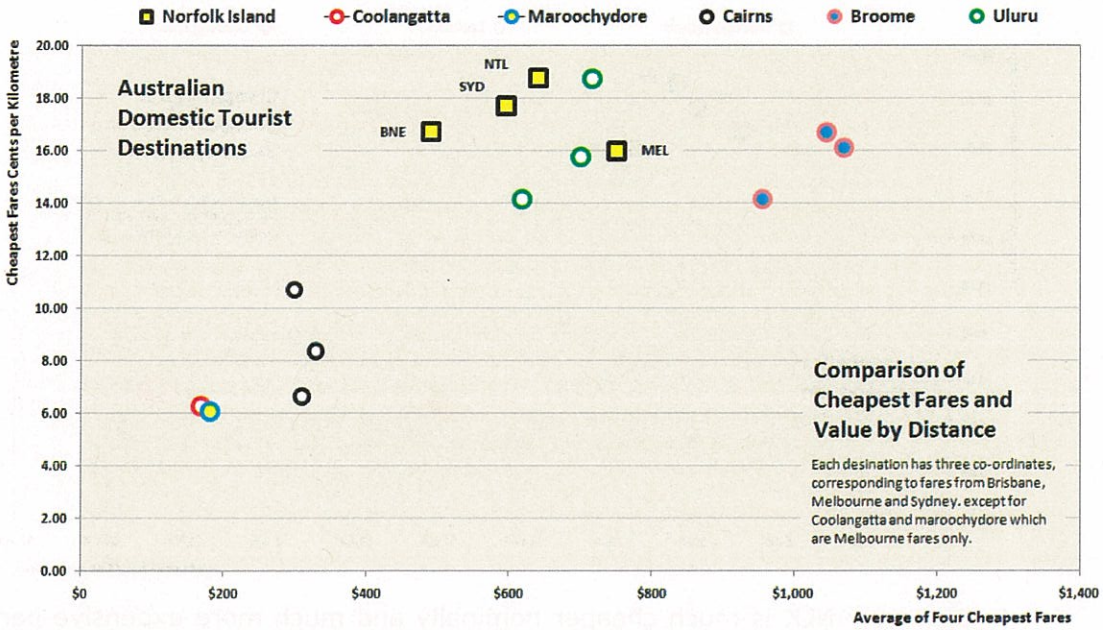


- Among regional alternatives, NLK fares are similar to those to Vanuatu and Fiji, and slightly less than those to Singapore and Bali. But again, on a value basis, they are above all ports except Noumea. Singapore, Honolulu, Bali and The Cook Islands (Raratonga) are much better value.

- Obviously NLK is much cheaper nominally and much more expensive per kilometre than long international routes. But it is interesting to note that Los Angeles is only about twice the price, but better value by a multiple of around four. This is perhaps a numeric description of the increasing competition from even long haul destinations.



- The Tasman comparison shows a remarkably wide spread of fares and therefore fares per kilometre. NLK fares occupy the top half of that spread in terms of fares, competing with Christchurch and Queenstown.
- In per kilometre terms, all New Zealand fares are much lower, except for two demand-inflated Queenstown fares.



- Major domestic tourist routes are much cheaper and better value as you would expect. But it is interesting to note that Uluru fares are similar, and both Uluru and Broome have high per kilometre values. Fares to Broome are much higher.

Observations

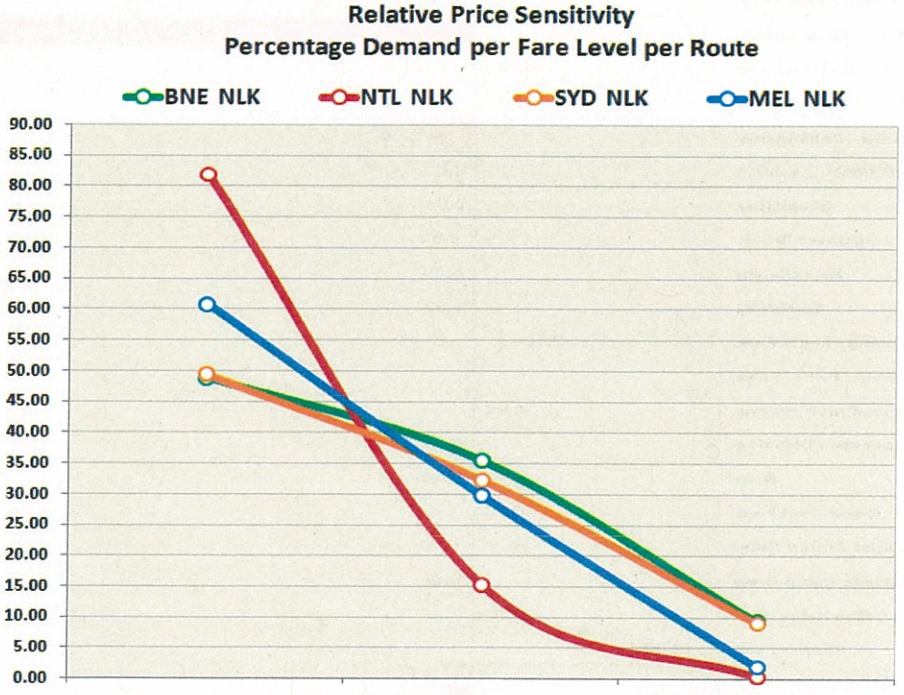
- It is interesting to consider those destinations with similar or higher fares per kilometre, and what might cause or enable such pricing.
- Noumea is serviced by only two airlines that do not compete aggressively with price. The capacity on the route is perhaps inadequate and the cause.
- There are no known structural causes for the high Queenstown fares. We suggest it might be due to the attractiveness of the destination, supported by heavy and effective marketing and very broad and effective distribution.
- So too with Broome and Uluru, but to a lesser extent we suggest. Broome thrives despite isolation and high pricing, and may be an interesting case study for growing tourism to Norfolk Island.

Conclusion

- This section pertains to the question, to what extent can fares to Norfolk Island be raised without damaging demand. We suggest that the comparisons suggest that there is very little competitive potential to raise fares from already high levels on a per kilometre basis.

5 Price Sensitivity

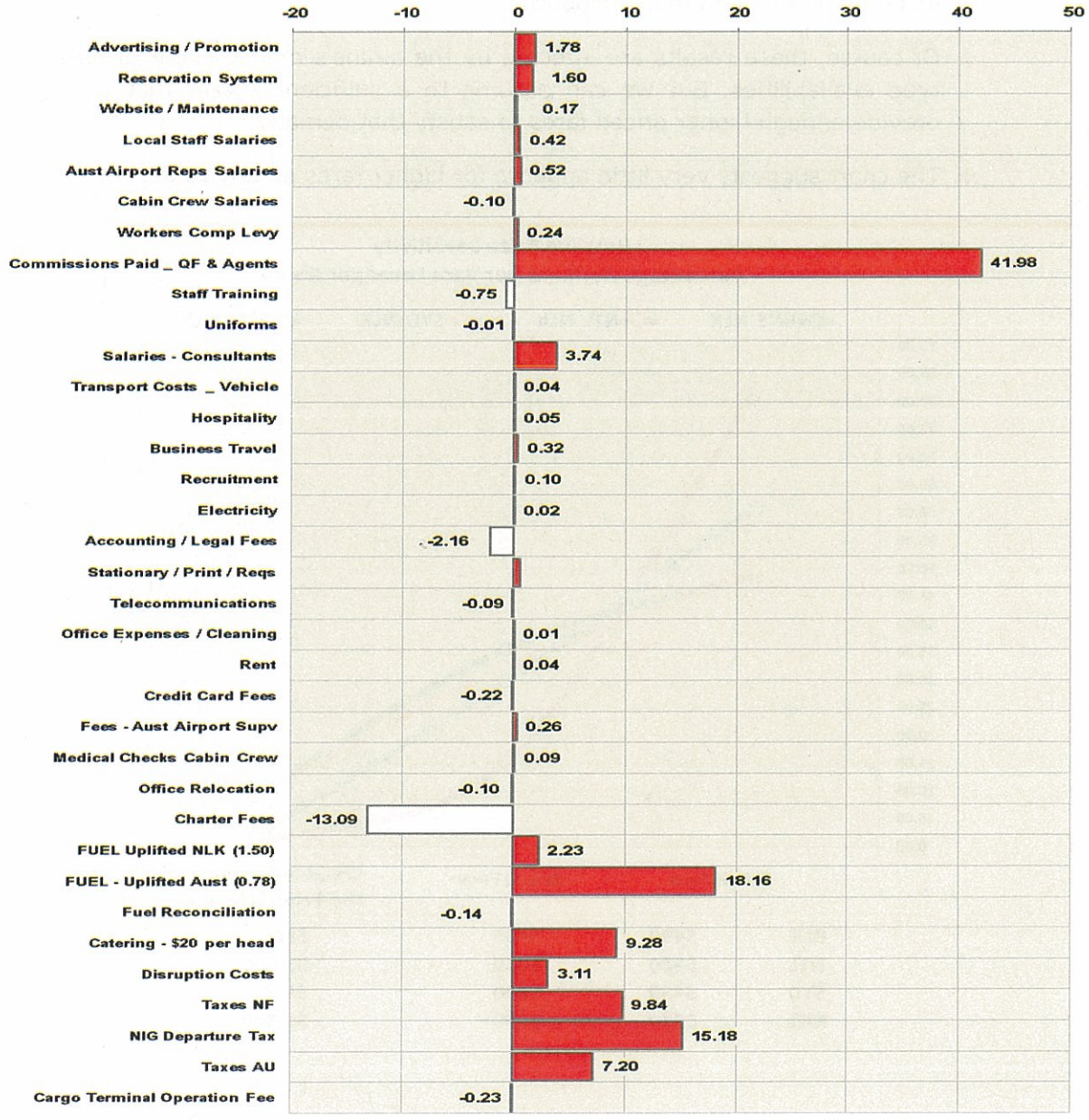
- Another method of determining the likely net revenue effect of changing fare levels would be to plot many fare and volume pairs over time. The detailed data necessary to do such an analysis is not available.
- The following chart gives an indication of demand price elasticity. It shows, for each NLK route, the percentage of fares sold per fare level / category over the most recent available 12 month period of constant fare levels (to 7/10).
- It is interesting to note the very low number of seats sold at the higher non-sale fare levels. Price sensitivity is high on all routes, but particularly so on Newcastle and then Melbourne.
- Of course, these results are effected by the airline's management of fare type availabilities. But we can assume to a sufficient extent that they provide enough higher priced fares to satisfy that demand.
- The chart suggests very little appetite for higher fares on any route.



BNE	$430	$600	$869
NTL	$480	$650	$1,000
SYD	$480	$650	$950
MEL	$630	$800	$1,346

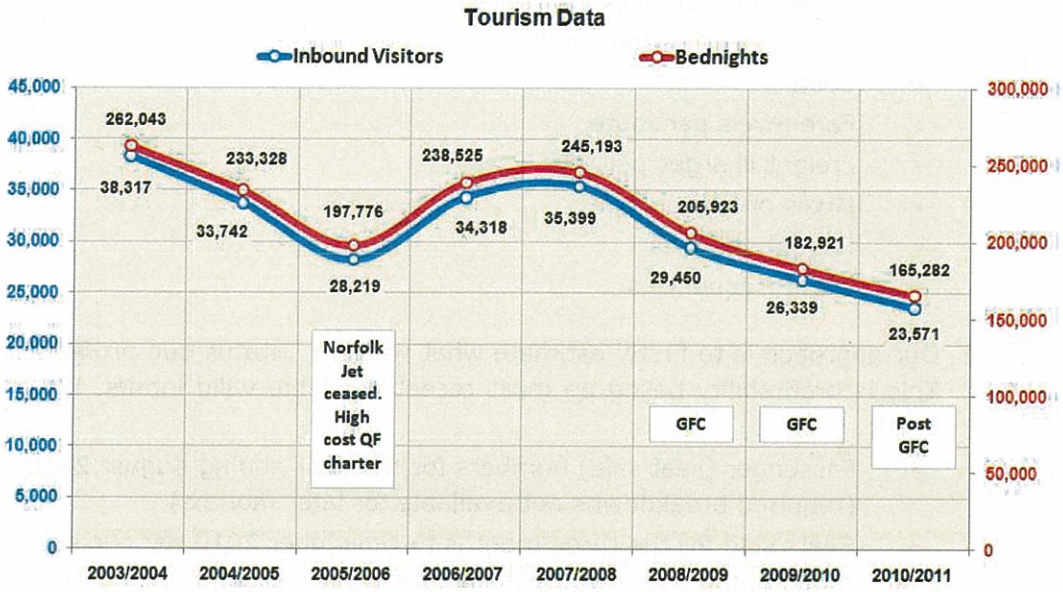
6 Airline Costs

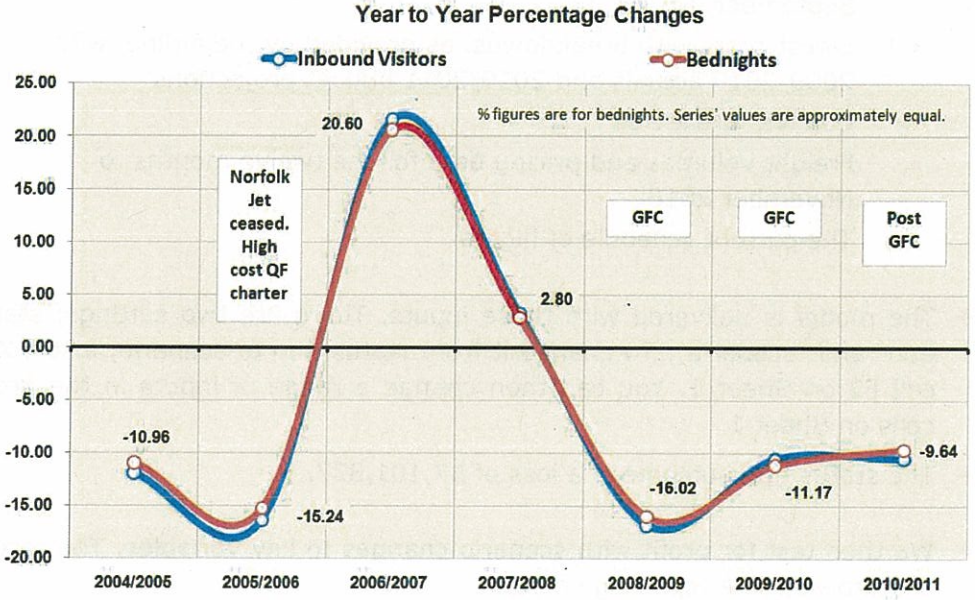
- The airline projects that costs will increase by 10.7% in the current financial year.
- The following chart shows the projected percentage contributions to that increase per cost item.
- The largest contribution is the addition of $970,000 in agency and Qantas commissions. The reason for and benefit of this should be investigated. Money spent on better broader distribution may be money well spent, but is not necessarily effective. The increase from zero suggests a new situation or strategy.



7 Tourist Numbers

- Data was provided by the airline, which we have analysed and present in the following charts.





- 2010/2011 annual figures are projections calculated by applying the average proportion of the first five months of data to the annual totals in previous years to the available first five months of data in 2010/2011.
- Average length of stay has remained constant in a range between 6.8 nights and 7 nights, influenced by flight schedules, and suggesting the prevalence of packaged tours.

8 Norfolk Air Profitability

- The accompanying Excel-based model enables the airline's profitability to be estimated based on values for:
  - Passenger numbers per route
  - Fare type mixes per route
  - Costs
  - Fare levels per route
  - Freight charges per type
  - Mixes of freight type
  - Freight volumes
  - Flight frequencies

- Our approach is to firstly estimate what we term "status quo profitability". This is profitability based on most recent available valid inputs. We have used:
  - Passenger (seat sale) numbers for the year ending August 2010 (required breakdowns not available for later months)
  - Seats sold for the three months to November 2010 per current range of fare types since those fare types were introduced in September 2010
  - Latest costs with breakdowns, as provided by the airline, with 2009/2010 actuals and 2010/2011 budget projections
  - Current fare levels
  - Freight volumes and pricing data for the twelve months to November 2010
  - The current schedule of flights

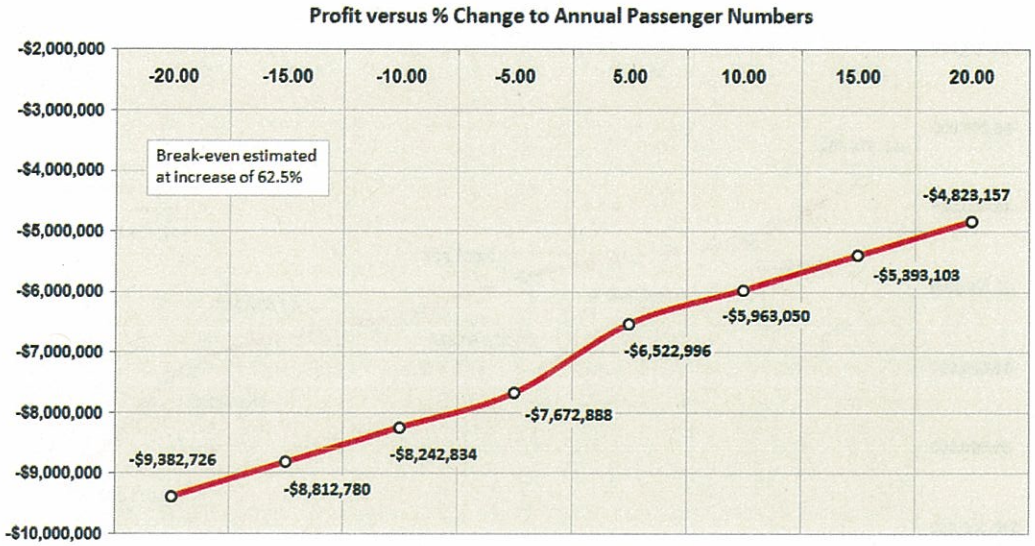
- The model is delivered with these inputs. There are two settings;"status quo" and "scenario". To change it from status quo to scenario, insert X in cell F2 on Sheet 1. You can then change a range of inputs in the green cells on Sheet 1.

- The status quo outcome is a loss of $7,101,337.

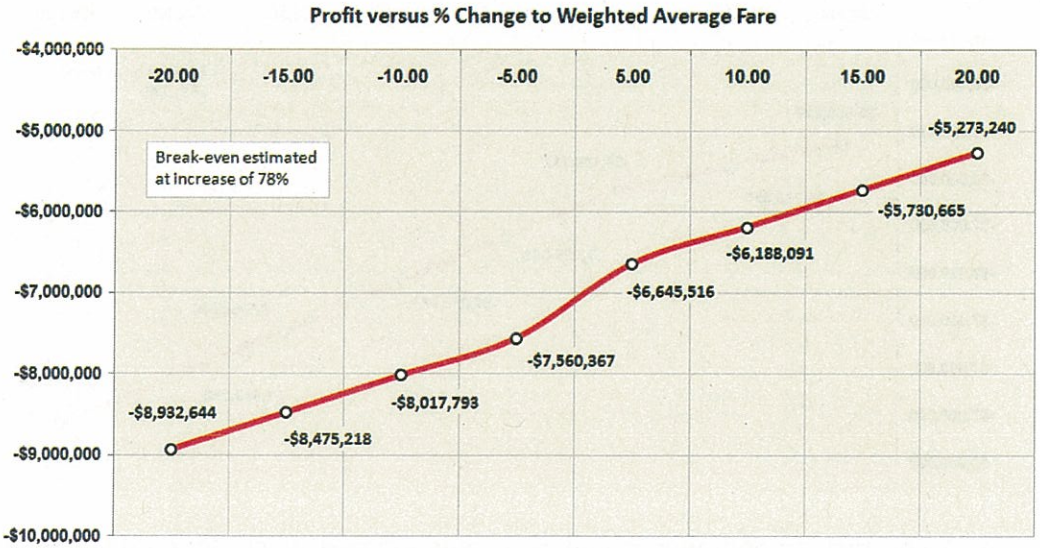
- We then test for profit with scenario changes to key variables. The results are shown in the following charts.

- The model is provided so that you can test for profit with your own scenarios and inputs.

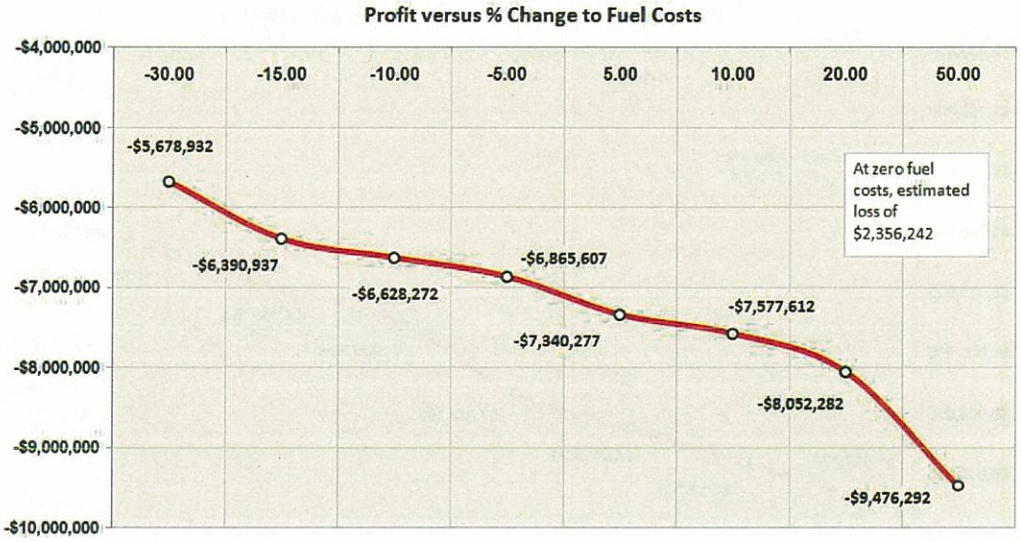
- The airline's 2010/2011 budget includes other sources of revenue, such as taxes, that are outside the scope of this exercise. They are included in the calculations as presented, but can be changed in the model.



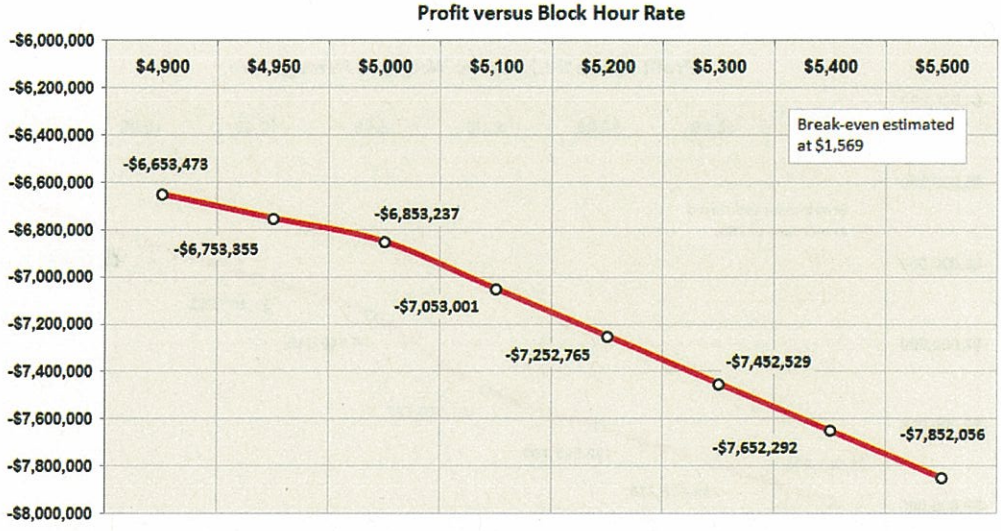
- The model produces the above profit outcomes at different percentage decreases and increases in overall passenger numbers. Even with a 20 percent increase, a substantial loss is still forecast. With all other inputs remaining at status quo levels, passenger numbers alone would need to increase by over 60% to achieve a zero loss.



- The model produces the above profit outcomes at different percentage decreases and increases in fare levels. Even with a 20 percent increase, a substantial loss is still forecast. With all other inputs remaining at status quo levels, fare levels alone would need to increase by around 78% to achieve a zero loss.



- The model produces the above profit outcomes at different percentage decreases and increases in fuel costs. Even with a 30 percent decrease, a substantial loss is forecast. With all other inputs remaining at status quo levels, if fuel costs were to be zero, a loss of around $2.3 million is estimated.



- A contract amendment including a renegotiated block hour rate with Air Nauru is currently under consideration. The model produces the above profit outcomes at different block hour rates, spread around the offered rate of $5,125. Even with a low rate of $4,900, a substantial loss is forecast. With all other inputs remaining at status quo levels, a rate of $1,569 would be required to achieve a zero loss

- The following three scenarios were tested in the model, with the profit outcomes shown.

Three Possible Senarios		A: Mild Improvement	B: Mild Deterioration	C: Moderate Deterioration
Greatest Impact	% Change to Annual Passenger Numbers	5.00	-5.00	-10.00
Major Impact	% Change to Weighted Average Fares	5.00	-5.00	-10.00
Minor Impact	% CPI	2.50	4.00	4.50
Minor Impact	% Wage Inflation	3.00	5.00	8.00
Moderate Impact	% Change to Fuel Costs	-10.00	10.00	20.00
Constant	Block Hour Fees (Current = $5,125)	$5,125	$5,125	$5,125
	Profit	-$5,000,211	-$8,612,112	-$10,042,540

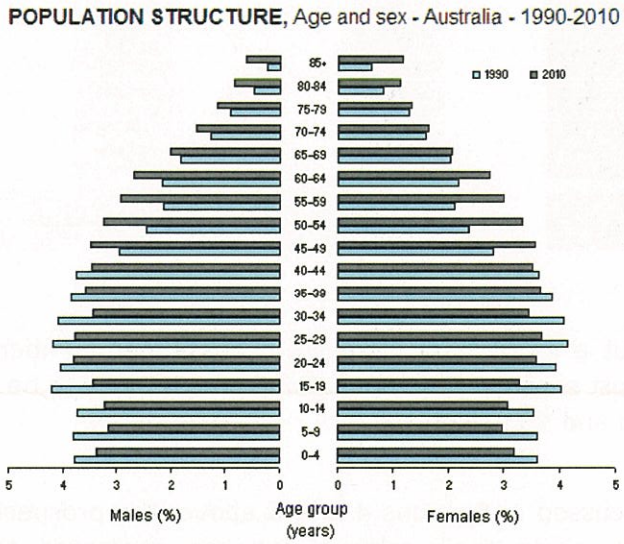
- Without a substantial increase in passenger numbers, to which profit is the most sensitive, the annual outcome is likely to be a loss of between $5 million and $8 million.

- As discussed in Sections 4 and 5 above, the prospect for increasing fares is low, given their relative expense compared to competing tourist destinations, and given the very low historic purchase of more expensive flexible fares.

- Changes to manageable operating costs have a relatively minor impact if profitability is being considered, given the amount of estimated loss at current passenger levels.

9 Tourism Infrastructure

- Norfolk Island has historically been a popular destination with older Australian tourists. A decline in this bracket of the population would therefore offer some explanation of the fall in tourist numbers. However, ABS population statistics show the opposite. Relative and absolute population numbers in the fifty to seventy-plus bracket are rising and will continue to rise.



- But a population bracket is not static. New individuals with different tastes and expectations enter and replace the population of the group.
- The tastes and expectations of the Australian population have changed and risen over the past ten years to the point where perhaps an increasingly large proportion of the older age group are no longer well catered for by the accommodation and other facilities on the island, which have not changed greatly over the past decade. As a visitor to the island in 2000, and again in 2011, I found that the quality and type of accommodation had not changed significantly.
- In my opinion, the standard of accommodation is well beneath that of the competing destinations considered in Section 4, in a similar price range. To support this assertion, reviews were made of accommodation at these destinations using the online sites tripadvisor, kayak and wotif.
- In particular, accommodation on the island lacks:
  - Air conditioning
  - Room service
  - Swimming pools
  - Modern decor

- A problem explained to me when I was on the island in January was that many of the properties are owned by small businesses, many being couples or individuals. Some purchased their accommodation businesses as a means to gain residence on the island as business owners. Many did so ten or more years ago. The outcome is that a large proportion of accommodation owners and operators do not have the funds or perhaps the inclination to invest in major upgrades. Under these static circumstances, the quality of the accommodation on the island would tend to deteriorate.
- It seems likely therefore that some mix of new ownership of existing properties and investment into new properties is necessary to improve accommodation on the island to a level that would raise the island's popularity with an increasingly sophisticated population of older Australians, who are presented with many more affordable tourism destinations than in decades past.
- If younger tourists were sought, however successful the marketing of the island and distribution, I believe that the quality of accommodation would have to be raised significantly to capture and keep this market.

- A "chicken and egg" situation obviously exists, since investors are needed to improve accommodation to attract tourists, but potential investors need strong prospects of better tourist numbers.

- Other improvement may also be necessary to restore tourist numbers.
- I observed that most shops in Burnt Pine were closed on Wednesday afternoon. It happened to be raining at the time and so there was little else to do than shop. It was explained to me that the Wednesday afternoon closure was a compensation provided to shopkeepers for opening on weekends. This is a problem in its own right, but more so if it is symptomatic of the general opinion of residents regarding the efforts needed to attract and satisfy tourists in a highly competitive market.
- The shops themselves, on average, seemed to contain too much old stock. Too much of the stock was decorative objects.
- Duty free pricing is likely to be less of an attraction to potential tourists, with the lowering of duties, highly competitive pricing in home markets, and internet shopping.
- Overall, I would describe the shopping facilities on the island as tired, and in need of restocking and new vigour.

10 Marketing and Distribution

- Norfolk Air faces a distribution problem common to small carriers. It faces a cost barrier to GDS distribution.
- GDS stands for Global Distribution System. They are the large global travel booking systems used by nearly all travel agents worldwide to locate and book travel product. Increasingly, internet based booking sites also connect to them. There are a few global GDSs that dominate the market. They are Sabre, Galileo and Amadeus. There are fourth and fifth systems in different regions of the world. Simply, having your product on the major GDSs opens up large channels of distribution. Without GDS presence, customers must book directly with the airline, have their travel agent do so, or buy the travel as part of a package constructed by travel wholesalers and on-sold to agents. Agents are averse to booking non-GDS travel since it is a manual process. The island has relied heavily on direct airline sales and packaged tourism via wholesalers.
- The GDS problem is one of cost. The airline advises that it would cost around $50,000 to establish, which is affordable. But then it would face high ongoing costs due to the fee structure of the GDSs. They charge for a minimum number of annual sectors booked, around 400,000. But Norfolk Air has less than 100,000, and not all would be booked via a GDS.
- If the airline were to be assisted financially, perhaps help with negotiation and then with GDS sector fees would be an effective use of funds, since it would open up new distribution opportunities.
- Regarding wholesalers, eleven are currently used. The top five account for over eighty percent of seats sold by this channel. The question is whether to consolidate the number, so as to motivate those remaining to market packages more energetically, or whether this would have little effect other than eradicating the other twenty percent. My view is that sustained greater effort from a wholesaler is unlikely due to the island's relative size as a product unless a particular marketing campaign driven by the island and the airline supported the remaining wholesalers. Without such a campaign, I would tend to leave the situation as it stands.
- If GDS distribution was enabled, there would then be an opportunity to drive sales through powerful retail agency groups, such as Flight Centre, HWT, Travelscene and JTG. Retail agents are motivated by commissions. A strategy could be to negotiate with one interested group. If any subsidies were to be provided to grow tourism, commission payments could be an effective use of funds. Since the island is a small product in a crowded market, the commissions should be structured around results, and be based on guaranteed internal promotions within the group and minimum external advertising over a period.
- This applies to accommodation also.

11 Comments and Conclusions

The profitability and likely future profitability of Norfolk Air

- We estimate that under the status quo conditions of the model, which are:
  - Current schedule
  - Current fare levels
  - Passenger numbers as per the year to 1/9/2010
  - Passengers per fare type per route as the first three months of the current fare structure ending 1/12/2010
  - Costs as per the airline's 2010/2011 budget
  - Current freight charges
  - Freight volumes and freight type mixes as per the year ending 1/11/2010
  - Assumptions regarding ancillary fee occurrence as shown on Sheet 2 of the model
- That the airline would lose over $7 million annually.
- Based on the results of the scenario testing described in Section 8 above, the airline would likely lose over $5 million whatever other changes occur in the absence of a substantial recovery in passenger numbers.
- The deterioration in passenger numbers over 2010 follows two years of decline following the GFC. The more recent decline cannot be said to be GFC related. Another cause is likely at play, which is probably the deterioration of the popularity of the island with the target older tourist market segment. If this is so, passenger numbers are unlikely to recover unless action is taken.

Factors that might improve or decrease the profitability of Norfolk Air

- The charts in Section 8 show the sensitivity of profit to key factors. It is clear that passenger numbers have the strongest influence, followed by fare levels. Cost factors are secondary in comparison. Sections 4 and 5 suggest that an increase in fares would reduce passenger numbers so as to reduce rather than increase revenue.
- This confirms that a recovery in passenger numbers is necessary to reduce losses significantly with the current schedule.
- Reducing the number of flights is a possibility, but this would likely prevent a recovery in tourism. An exception might be the Newcastle route, on which numbers are poor and price sensitivity very high.
- If the schedule was to be cut, costs may not fall sufficiently if the current amendment to the contract with Air Nauru was in place, if block hours fall

beneath 2,000 per annum. Any reduction in flights should be determined beforehand, with negotiations proceeding on the changed schedule.

Given that that a key determinant of profitability is tourist numbers, the likely outlook for and determinants of tourist numbers on Norfolk Island

- As shown in Section 7, instead of recovering from an external shock as they did five years ago (after the airline collapse), tourist numbers are declining rather than recovering after the removal of the impact of the GFC. Tourism and tourist numbers have recovered strongly in Australia and in most other parts of the world, but not to Norfolk Island..
- It is useful to consider possible causes of the decline in tourist numbers in terms of external and internal causes, relative to Norfolk Island.
- We suggest the following significant externals causes:
  - The increasing sophistication and affluence of older tourists in Australia
  - An increase in the number of competing destinations, and more and better facilities at competing destinations, especially regionally
  - The growth of low cost carriers and the flood of cheap fares, initially domestically and now regionally
- And these internal factors:
  - The static and possibly deteriorating stock of accommodation on the island, increasingly beneath the minimum acceptable levels of the changing older target market in Australia
  - The diminishing attractiveness of the shopping on the island, due to the sophistication affect and the spread of cheap prices at home and via the internet.
- Also:
  - The lack of GDS distribution for airfares and accommodation foregoes the main industry distribution channel to travel agents, leaving an over-reliance on direct sales and wholesale packagers. Direct sales need expensive marketing and advertising, and wholesalers are apt to neglect minor or marginal products.

Suggestions:

- If funds were available for support of tourism in the island, and if any such funds remained after supporting the airline in the short and possibly medium term, then two effective applications of the money might be:
- Enabling GDS distribution of travel product, if good terms could be negotiated with a GDS and one or more powerful travel agency group
- Surety as support for "kick-start" private sector investment into accommodation on the island, supported by an effective campaign to improve tourism services generally