

# Productive and Dynamic Efficiency

# Overview

- The Commission believes there would be major productive and dynamic efficiency losses as a result of the Alliance
  - Productive efficiency loss: \$95m
  - Dynamic efficiency loss: \$90m
- These estimates are based on a fundamental misunderstanding of how the market will evolve as a result of this Alliance
- In fact, we believe there are far more likely to be substantial *gains* in productive and dynamic efficiency, and show that there are strong grounds for holding this view

# Productive Efficiency

The Commission's approach to assessing productive efficiency effects is incorrect at multiple levels

Less Competitive Pressure



Lower productivity



Higher Costs and Lower Outputs



Detriment of \$25-180m

A. Competitive pressure will not weaken

B. Factors affecting productivity will be enhanced by Alliance

C. Calculation errors and implausible results

# Productive Efficiency

## A. Competitive forces will not be weaker under the Alliance

- The Applicants will face intense competition in most routes affected by the Alliance
  - VBA entrant with cost advantage
  - 5<sup>th</sup> freedom carriers across Tasman
- Most capacity will continue to be supplied under conditions unchanged by Alliance
  - QF will continue to earn over 80% of revenues from routes not affected by Alliance, and continue to face intense competition on those routes
  - It is therefore implausible that Applicants would sacrifice competitiveness in long haul operations e.g. by allowing wage creep on routes affected by Alliance
- Furthermore, market for corporate control would take notice of inefficient behavior, especially if it threatened the overall viability of the company

# Productive Efficiency

## B. Factors affecting productivity will be enhanced by the Alliance

### Factors Affecting Productivity Identified in Empirical Literature

Factor	Link to Productivity	Effect of Alliance	Impact on Productivity
Economies of density	Reduces cost (capacity utilisation)	Greater realisation of economies of density	Positive
Private ownership	Reduces cost (capital mkt discipline)	Improved access to private equity with good performance	Positive
Benchmarking	Reduces cost (learning)	Increased sharing of operation & technical information	Positive
Economies of scale	Reduces cost at low output	Gain in economies of scale	Slightly positive
Market concentration	Tenuous	No <i>meaningful</i> impact	Negligible effect

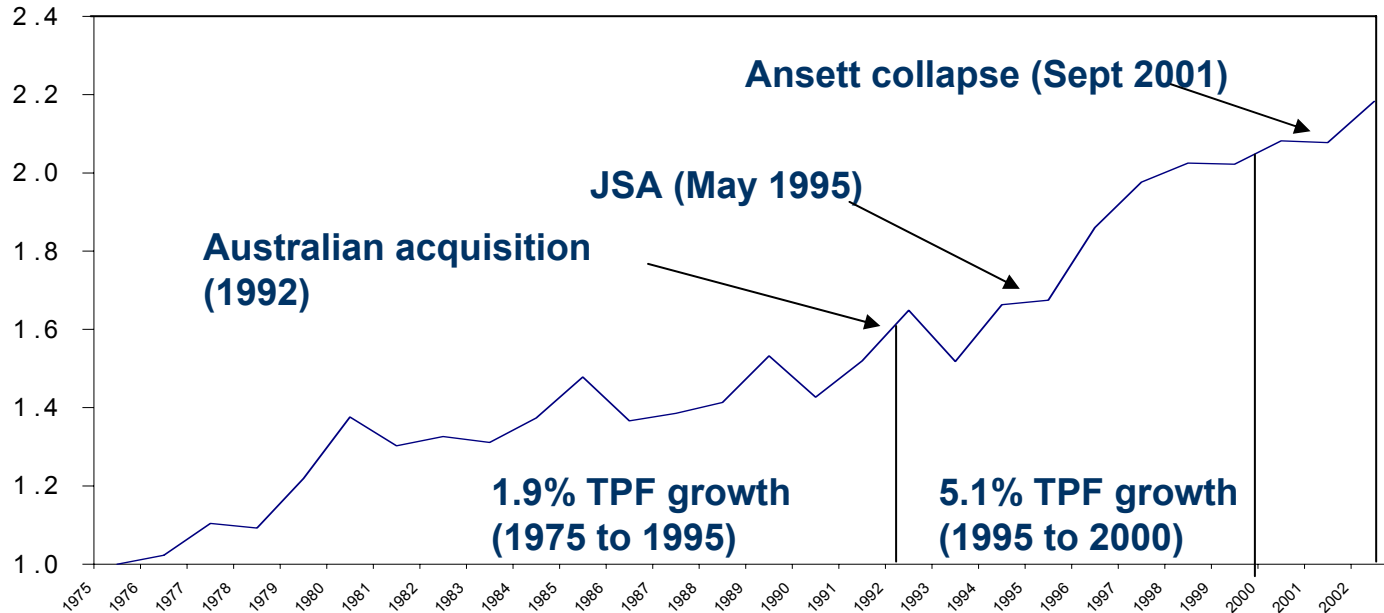
# Productive Efficiency

B. Based on the OECD's framework, we find that the Alliance will not reduce productivity

- The Commission claims OECD study supports negative link between productive efficiency and market concentration
- In reaching this conclusion, however, it takes no account of the other factors specified in the study that would affect productivity
- No statistically significant difference in productive efficiency between Factual and Counterfactual is implied by the OECD equations

# Productive Efficiency

B. The major boost to Qantas' total factor productivity was the JSA



Since Ansett's collapse, Qantas' annual TFP growth has been 5.1%

# Productive Efficiency

Today, Air New Zealand and Qantas are both relatively efficient airlines

- Demonstrated by analysis of technical efficiency for Qantas and 25 other airlines (2000)

Inputs	Outputs
(1) Labour units (2) ASKs (3) Other costs	Multilateral output index, derived from: (1) RPKs (2) Tonne km (3) Other

## Technical efficiency scores

Qantas	0.94
Air NZ	0.89
Average	0.83

The Alliance provides opportunities to consolidate and further improve their good relative performance



# Productive Efficiency

C. The Commission proceeds to quantify losses that are inappropriate to ascribe to the Alliance; this fundamental error is compounded by calculation errors and a failure to provide simple reality checks

- Triple counting
  - Cost savings from new entrant used in calculations are also counted in calculating dynamic inefficiency losses and allocative efficiency losses
- Failure to distinguish transfers from costs in estimating wealth effects
  - Commission interprets x-inefficiency as genuine economic efficiency
  - However, not all x-inefficiency is waste – some is transfer of income
- Reality checks
  - Results imply that the parties are irrational in pursuing the Alliance: potential profits (\$88.6m) will be lost through productive inefficiency costs (\$95m)
  - Economic literature shows that that major airline alliances improve productivity
    - No studies show that alliances lead to deterioration in productivity performance
    - Largest study (Oum et al) found that major alliances raise productivity by 4.9%

# Productive Efficiency

The Commission's views on productive efficiency are also inconsistent with its views on allocative efficiency

## Implications of Commission's Position on Allocative Efficiency and on Productive Efficiency

Allocative  
Efficiency

Agency problems greater in CF than F

- F: Applicants are profit maximisers
- CF: Applicants are revenue maximisers

Productive  
Efficiency

Agency problems greater in F than CF

- F: High level of managerial slack
- CF: Low levels of managerial slack

# Dynamic Efficiency

The large dynamic efficiency losses the Commission ascribes to the Alliance are not defensible

- The Commission's view that the Alliance would harm dynamic efficiency are entirely dependent on an assumption that VBA entry would occur on Tasman routes under the Counterfactual but not the Factual
- This assumption is fundamentally incorrect, for reasons discussed in detail in previous submissions
- Even if the assumption were correct, the Commission's calculations of dynamic efficiency losses contain errors that dramatically inflate their magnitude

# Dynamic Efficiency

Even if the assumption were correct, the Commission's calculations of dynamic efficiency losses contain errors that dramatically inflate their magnitude

- Treats the *entire* difference in costs between the VBA and the incumbents as a measure of the detriment from foregone entry
  - Ignores difference in service quality
  - Adjusting for quality would lead to much smaller detriment
- Assumes the VBA is New Zealand owned – if foreign ownership recognised reduces Commission's estimate of dynamic efficiency loss by 57% under median scenario
- Involves double counting, since losses are already included in Commission's assessment of allocative efficiency detriments.

# Conclusion

- The Commission's estimate of a \$185m in detriments due to productive and dynamic efficiency losses, comprising over 50% of its total detriments, are not supportable
- Consistent with all the empirical research in this area, the Applicants believe that there will be substantial *gains* in productive efficiency as a result of the Alliance, and no losses in dynamic efficiency

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