Rejoinder to 'Response to Submissions in relation to NECG's Report

by Tim Hazledine
Professor of Economics
The University of Auckland

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1. The Network Economics Consulting Group was commissioned by Air New Zealand and Qantas to put the economic case for their proposed cartel covering these airlines' operations in and out of New Zealand. The New Zealand Commerce Commission and the Australian Consumer and Competition Commission posted the NECG Report and invited submissions, which they received from a number of interested and independent parties, including amongst the former Frontier Economics on behalf of Virgin Blue, and amongst the latter my own analysis of the situation.

On March 5, 2003, the Commissions posted a revised set of figures from NECG, with a brief covering letter. Later, NECG's 64-page response to the submissions was posted. What follows is my own rejoinder to NECG's response and the revised figures.

2. Independent analysis of this very important proposal has been made unnecessarily difficult and imprecise by the decision of the Commerce Commission and the ACCC to allow NECG to delete as 'confidential' from the publicly available version of their Report the assumed 'counterfactual' airline schedules of Air New Zealand and Qantas (and other matters). It may be for this reason that mine was the only one of the dozens of submissions made that actually produced an independent modelling effort to compare directly with the NECG's analysis.

No doubt the parties claimed that their counterfactuals were 'commercially sensitive' information. But it is hard to see that these hypothetical and non-binding projections are really any more truly commercially sensitive than the 'factual' schedules, the details of which were not deleted from the Report. What seems most likely is that the parties – especially Qantas -- simply didn't want their counterfactual fully exposed to outside scrutiny. That is indeed understandable from their point of view, but it is less understandable that the authorities, whose point of view is of the public interest, let them get away with it.

The Commerce Commission and ACCC themselves have access to the counterfactual and the spreadsheet model used by NECG. These agencies have their own competent analysts, but free competition in ideas is surely at least as valuable here as everywhere else. The competition authorities have, in essence, preserved for themselves a monopoly over the full set of information needed to thoroughly assess the NECG model. The irony of this is obvious.

3. NECG respond to my submission, which, as they note, is 'extremely critical' of their analysis, writing down their claimed efficiency benefits from the cartel of around $700 million/year to no more than $20 million, and boosting the deadweight inefficiencies to lie in the $200-300 million/year range. In the range of simulations I covered, a consistent outcome was that Qantas was always a winner to the tune of around $200 million/year, but the New Zealand public and Australian consumers lost much more than this.

NECG quite like parts of my model, as indeed they should since I took as much of it as I reasonably could from their own model, in order to reduce as far as possible unnecessary sources of disagreement. But they assert that 'Hazledine introduces crucial new assumptions without making them explicit. These new assumptions, that essentially determine his results, are, however, manifestly implausible.' (p45)

This is rhetorical flim-flam. Some of the results are indeed manifestly implausible. *That is the point*. These are, in essence, their results, not mine! The assumptions are not 'new'; they are implied by the NECG scenarios.

What I did was unveil those implications. I pointed out that if Qantas, in particular, piled on extra capacity as assumed by NECG's counterfactual, then if they were to actually fill those seats they would need to cut prices very close to marginal costs, such that no profits would be earned. Such may indeed be implausible; it may even be illegal (because predatory).

On the other hand, if the extra capacity is not used, as seems to be implied by the NECG's model, then you would see some very low load factors, leading to the Get-That-Elephant-Off-My-Foot cost 'savings' from the cartel that I exposed in my Submission.[1]

4. I did assume in my model that the existing or base-case state of competition between Air New Zealand and Qantas is rather more aggressive or competitive than the Cournot behaviour assumed by NECG. This assumption, which is consistent with remarks made in the NECG Report[2], is supported by my own previous empirical work analysing the nature of competition on the Tasman routes since Air New Zealand and Qantas dealt to Kiwi International in 1996.[3] It makes a difference to the results because it implies that that leap in prices if the cartel were permitted would be higher.

The Counterfactual

5. NECG are in a very tricky position with respect to their assumed 'counterfactual' prediction of what would happen if the cartel is not permitted. If they make this very unattractive through large increases in capacity by Qantas, then they are vulnerable to criticisms (as made above and in many submissions) that such behaviour would be at best commercially non-viable and at worst illegal. But if they assume a business-as-usual counterfactual, then it is hard to make the case that the cartel is necessary to the continued viability of Air New Zealand, especially given the latest profit figures reported by that airline in the wake of the introduction of their innovative 'Express Class' fare structure.

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[1] 'The result [of implementing the counterfactual] would be to significantly increase costs, reduce load factors and/or yields and cut profits.' (NECG Report, p14.)

[2] 'As for the Tasman [market], given capacity costs and load factors, prices are already too low to allow an economic rate of return to be earned.' (NECG Report, p14.)

[3] NECG in their Response report (n27, p49) that they have been 'unable to obtain a copy' of my paper documenting these findings. They only needed to ask!

The Factual

6. NECG are also in a very tricky position with respect to their 'factual' prediction of life under the cartel; in particular, with the expected role to be played by Virgin Blue, the most likely low-cost entrant. They really have to claim that the cartel would make entry more likely, or else the anti-competitive impact would be prohibitive. But if entry is too effective, then – as any modeller of Cournot-Nash oligopoly knows – the merger or cartel itself becomes commercially unattractive: even with higher prices, the loss of market share to the entrant reduces the size of the slice of the profit pie to be shared between the two incumbent firms.

7. As I pointed out in my submission, NECG suppress this problem by limiting arbitrarily Virgin Blue's capacity. In essence, they tell passengers which airline they are to fly with. Now, NECG criticise me for in effect accepting this procedure, and trying to make sense of it in my model by assuming limited substitutability in demand between the services of the incumbents and a value-based airline.

But if, instead, the products are quite close substitutes, as NECG argue, perhaps correctly, on pp 45-6 of their Response, and given the admitted cost advantage of Virgin Blue – which may here be underestimated[4] -- it is very hard to write down a model which does not predict that Virgin would take up to one half or even more of the market from Air New Zealand and Qantas. And this means -- at least given NECG's assertion that entry is unlikely or less likely absent the cartel – that the cartel could not possibly increase the profits of its members.

Cost Efficiencies.

8. In my Submission, I claimed that NECG had committed a billion-dollar error in proposing cost efficiencies totalling $300 million/year (or more than $1 billion in total over the five years covered in their analysis) from the Auckland-Singapore and Auckland-LAX routes. I termed these numbers 'literally incredible' as were forecasts of cost *increases* on various flights around the Pacific and Asia amounting to $65 million/year.

These huge numbers were placed on the table with absolutely zero supporting argument or explanation in NECG's original report, and in their revision of March 5 they are (nearly all) taken off the table with equal lack of fanfare.

Tourism benefits

9. The other source of huge benefits claimed for the cartel by NECG is from forecast increases in tourists travelling, in particular, to New Zealand. Both the forecast increases and their assumed benefits were heavily criticised in submissions, including my own.

In their quite brief response to the critics (pp 54-57) NECG reiterate their claim that the Qantas subsidiary Qantas Holidays would provide the additional tourists.

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[4] NECG assume a 20% cost advantage to Virgin over Qantas. It is my understanding that VBAs in Canada, Europe and the US have been observed to operate with cost advantages over FSAs over equivalent routes of as much as 40-50%.

Now, it may well be that were Qantas Holidays' incentives realigned by this cartel such that serving the New Zealand market became relatively more attractive to them, that they would then find it profitable to funnel more tourists in our direction. But increased profit for Qantas Holidays does not necessarily equate to benefits to the New Zealand public. It is very disappointing that NECG in their response to their many critics choose to attempt to defend their economically illegitimate 'spending = benefits' methodology rather than conceding that it is inconsistent with the net surplus procedures (correctly) used in the rest of their Report.

10. The big point to bear in mind here is this. The deep-seated presumption that drives our competition policy is that competition is good and monopoly is bad. The burden of proof must lie with those who would find market failure in competition and seek to remedy this through monopoly or cartelisation. NECG failed to accept this burden in their original Report, and have done little better in their Response.

The Virgin Blue Submissions

11. The Australian airline Virgin Blue and their consultants, Frontier Economics, have argued that entry would be less likely because more difficult should the cartel go ahead. The incumbents and their consultants NECG argue the opposite. Who is to be trusted here?

On the one hand, any price-increasing merger or cartel should make entry more attractive because it increases the profit margin from supplying some new output to the market. On the other hand, a cartel could be more effective, because more coordinated, at deploying its forces 'strategically' to repel or deter entry.

Virgin and Frontier argue the latter case, and NECG respond on pages 17-23. Here, the balance of my sympathy lies with the incumbents' arguments, for two reasons. First, I agree with NECG that the specific problem raised by Virgin – access to facilities such as landing slots – is not very compelling. Second, having studied how Air New Zealand and Qantas dealt to Kiwi International, I am not convinced that they need a formal cartel structure to respond effectively (or as effectively as is commercially viable) to new competition.

12. So why are Virgin Blue making such a fuss? I don't know, but conjecture that they may expect that by so doing they will be pacified by some concession, such as being able to acquire Freedom Air from Air New Zealand. If so, then I would just caution at this stage that regulations or undertakings that make life easier for Virgin Blue are not *ipso facto* in the interests of the New Zealand public. They will need to be looked at very carefully, on their own merits.

The Wellington Airport Submissions

13. The third set of submissions to which NECG respond specifically are those of Wellington Airport and its consultants, Infratil.

Wellington Airport holds a local monopoly position which it has recently used to force through a spectacular increase in the landing fees charged to Air New Zealand and Qantas. While it is understandable that a monopoly would rather deal with two independent customers than one large combined party, this is perhaps the

one issue where the interests of the downstream travelling public and those of the proponents of this cartel are aligned.

The Bottom Line

14. NECG make some good minor points on behalf of their clients in their 64 page Response to submissions relating to their Report. But their failure to properly address the fundamental objections raised against their cost-benefit analysis should leave independent observers even more concerned than before about the dangers to the public good of permitting the proposed cartel to proceed.

t.hazledine@auckland.ac.nz