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Predatory Pricing in the Australian Aviation Sector

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1. Introduction

Australia has always posed challenges for commercial aviation operations. It has a population of just over 20 million spread over more than 7 million square kilometres. In terms of density of domestic air travel, around 500,000 scheduled flights move over 38 million passengers nearly 300 million kilometres per annum[1]. More than one third (39%) of all domestic passenger movements are along the strip of east coast between Melbourne, Sydney and Brisbane (see the map in Attachment 1), the largest route by far being the Sydney – Melbourne route[2].

There are 3 carriers who service the major domestic routes (main cities and tourist centres), being Qantas, Jetstar (a subsidiary of Qantas) and Virgin Blue, and a number of small carriers that service regional areas. Both Qantas and Virgin Blue are publicly listed companies traded on the Australian stock exchange (ASX).

The Australian aviation sector has experienced significant changes since deregulation of the domestic market in 1990. Previously, under the "two airline policy", statutory barriers protected the Government owned domestic carrier Australian Airlines (which merged with the Government owned international carrier Qantas in 1993) and the privately owned Ansett Australia, both of which operated as full service airlines.

Deregulation saw the entry by and subsequent failure of various budget carriers in the early 1990's. Complaints were made about the market conduct of the incumbents and

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[1] BTRE, Australian Transport Statistics, June 2005

[2] BTRE, Australian Transport Statistics, June 2005

their role in the failure of these new entrants. In each instance, investigations by the Australian competition regulator (the Australian Competition and Consumer Commission or ACCC) concluded that there was insufficient cause to take action.

In late 2000, the Virgin Group established a new low cost carrier in Australia, Virgin Blue. As has occurred in domestic aviation markets worldwide, the commencement of operations by Virgin Blue triggered a price war and the expansion of capacity by incumbents on key routes. The ACCC investigated this conduct and eventually commenced an action against Qantas for predatory pricing and "capacity dumping" (significantly increasing capacity beyond expected demand so that all competitors on the route would operate at a loss on the route until one of them withdrew), discussed later in this paper.

Ansett, however, was already in financial trouble and collapsed in September 2001. The demise of Ansett caused an immediate reduction in domestic capacity and enabled Virgin Blue to grow its market share to around 25% by the end of 2003 (when it publicly listed) and its present level of around 30%.

In November 2003 the ACCC discontinued the predatory pricing / capacity dumping action against Qantas on the basis that the market had changed, Virgin Blue had survived, and consumers were now benefiting from competition between Qantas and Virgin Blue on this and other routes. The ACCC raised concerns about the difficulty in prosecuting actions for predatory behaviour in aviation markets based in experience in other jurisdictions.

In early 2004, Qantas responded to Virgin Blue's growing market share growing and significantly lower operating costs by establishing its own low cost subsidiary, Jetstar, resulting in what has been described as a "re-organisation" of market share and creating pressure on Virgin Blue in the share market.

Fifteen years after de-regulation, the domestic market in Australia is once again characterised by two players, this time one full service airline (Qantas) with its own low cost subsidiary (Jetstar) and one low cost carrier (Virgin Blue).

The present situation in the domestic market raises a number of interesting issues for competition analysis in the aviation sector. In particular, it raises some fundamental questions about the use of costs tests in assessing predatory pricing by a dominant airline (especially where that airline has the ability to use a low cost vehicle), the nature of the legal and economic framework necessary to assess strategic behaviour and the nature of barriers to entry and expansion in domestic aviation markets.

This paper discusses developments in the domestic aviation sector during two periods, the first being from deregulation in 1990 to the collapse of Ansett in 2001 and the second being the post 2001 period to the present. The discussion includes some of the tactics employed by airlines during each of these periods to gain and preserve market share, the legal and regulatory response to these tactics and the economic issues which they raise.

2. Deregulation of the Australian domestic market

Under the "two airline policy", the two domestic carriers had little incentive to compete. Their pricing structures for full and discount airfares were, for all practical purposes, identical and therefore the services they provided became the major means of differentiation. A 1996 survey by the competition regulator of airfares in the 5 years post deregulation found that, whilst deregulation had lowered airfares overall, the greatest reductions had occurred while a third airline had been operating[3]. However, were these low fares sustainable and what did they mean for new entry?

Almost immediately after deregulation of the domestic market in 1990, new entry occurred in the form of Compass Airlines. Compass entered the market with much fanfare and the promise of price competition. By December 1991, average fares had dropped to 31.6% below pre-deregulation levels[4]. Compass received huge public support, not just in terms of passengers but also capital raising. It floated $50 million on the stock exchange and was oversubscribed by $15 million[5].

[3] ACCC, Air fares: before and after Compass, April 1996 (MR 050/96)

[4] ACCC, Infrastructure Industries, Aviation, May 2000

[5] Carlson A, Research Papers prepared for the IASC 1996/97, September 1997 (p11)

However, the incumbents responded with a savage and sustained price war and Compass found it difficult to gain access to adequate terminal space and slots. Within a year Compass was struggling financially and collapsed. An attempt to revive Compass came in 2002 in the form of Southern Cross Airlines (known as Compass Mark II), but within less than 12 months this too had failed.

Access to air terminals was a significant factor contributing to the failure of Compass Mark I and II[6]. An additional factor for Southern Cross was the fact that capital markets had learnt from the Compass Mark I experience. Southern Cross' attempt to raise $50 million was undersubscribed by 46%[7].

The lessons from Compass Mark I and II were clear. Successful entry by a third airline would need assistance in terms of access to terminals and, whilst market share could be built by offering low fares, two factors needed to be taken into account. First, the entrant would need to find a way to fund itself without resorting to capital markets while it built market share. Second, given the nature of the domestic market, building a large market share quickly would inevitably involve taking on the incumbents in the key east coast routes, particularly Melbourne – Sydney, and this would entail surviving a price war.

The next attempt at significant new entry did not occur until June 2000 when Impulse (a regional airline operating out of Newcastle north of Sydney) commenced services along the east coast as a 'budget airline' in competition with Qantas and Ansett. In response to complaints by Impulse, the ACCC investigated whether the addition of significant capacity by Qantas on the Newcastle – Brisbane and Newcastle – Melbourne routes in 2000 was a predatory response to Impulse, but concluded that there was insufficient basis for it to take any action (discussed further below). Less than 12 months later Impulse was facing financial collapse and in May 2001 Impulse was acquired by Qantas.

[6] ACCC, Aviation, May 2000

[7] Carlson A, Research Papers prepared for the IASC 1996/97, September 1997 p11

In the meantime, following changes by the Federal Government in 1999 which allowed up to 100% of a domestic airline to be foreign owned, Virgin Blue entered the market in August 2000 as a low cost carrier along the lines of the Southwest Airlines model which had met with success in other parts of the world. Virgin Blue, like Impulse, was faced with much the same issues that Compass Mark I and II faced, namely price wars and increases in capacity by the incumbents and difficulties in securing access to terminal facilities. For example, both Virgin Blue and Impulse had to commence their Melbourne operations out of the international terminal.

However, Virgin Blue's ability to overcome these access issues was assisted by three things.

First, in order to overcome objections by the ACCC to its acquisition of Impulse, Qantas agreed to make available to Virgin Blue up to 12 daily peak hour take off and landing slots at Sydney airport in order to enable it to provide Sydney – Melbourne services and to facilitate access to terminal space at Sydney airport[8].

Second, the Federal Government had in the meantime introduced an airport access regime that would apply to privatised airports such as Melbourne airport (discussed in Attachment 2). Virgin Blue used this process to seek access to domestic terminal facilities at Melbourne airport in March 2001[9].

Third, Ansett was already in financial difficulties and collapsed in September 2001. Amongst other things, this meant that Ansett terminal space at major airports became available (as did its market share).

3. Predatory Pricing under Australian law

Since deregulation, new entry has been accompanied by price cutting and capacity expansion, raising concerns about predatory behaviour. The economic perspective on

[8] ACCC Media Release 116/01, 18 May 2001

[9] ACCC Determination pursuant to section 192 of the Airports Act 1996, Application by Virgin Blue in respect of certain terminal services as Melbourne Airport

these issues is discussed in section 4 below. However, first this section sets out the relevant Australian legislative framework for dealing with predatory pricing.

The relevant legislative provision which deals with predatory behaviour is section 46 of the Trade Practices Act, which provides in subsection 46(1) that:

> "A corporation that has a substantial degree of power in a market shall not take advantage of that power for the purpose of:
> (a) eliminating or substantially damaging a competitor of the corporation or of a body corporate that is related to the corporation in that or any other market;
> (b) preventing the entry of a person into that or any other market; or
> (c) deterring or preventing a person from engaging in competitive conduct in that or any other market. "

The ACCC's investigations following the collapse of Compass and in relation to the complaints by Impulse concluded that there was insufficient evidence to pursue any action under section 46.

In May 2002 the ACCC did commence proceedings under section 46 against Qantas for responding to Virgin Blue's entry on the Brisbane – Adelaide route in December 2000 in an anti-competitive manner by "capacity dumping" (significantly increasing capacity beyond expected demand so that all three competitors on the route, Qantas, Ansett and Virgin Blue, would operate at a loss on the route until one of them withdrew)[10].

However, before the matter came to trial, the ACCC discontinued the action in November 2003 on the basis that "since the action began, the airlines market had changed and competition has been enhanced". The ACCC noted that Virgin Blue continued to operate on the Brisbane – Adelaide route and that "consumers have benefited from the competition between Qantas and Virgin Blue on this and other routes"[11].

[10] ACCC Media Release 108/02, 7 May 2002

[11] ACCC Media Release 245/03, 21 November 2003

The ACCC also remarked that "final resolution in the courts of this matter would have been extremely difficult, lengthy and expensive" and that "experience in overseas jurisdictions where similar cases have been instituted shows the uncertainty and delays such litigation faces"[12].

There are a number of difficulties in successfully using section 46. In order to understand these, it is necessary to refer briefly to the key elements of section 46 that must be established before the court.

First, it is necessary to show that the firm involved had a substantial degree of market power at the time of the relevant conduct. The Australian High Court (the ultimate appellate court) has made it clear that this is a threshold requirement for any section 46 argument. The High Court has also made it clear that market power cannot be established merely by the fact that the firm involved has engaged in a particular type of conduct.

Accordingly, it is not enough to demonstrate that, from an economic perspective, a firm with market power is typically able to engage in a particular type of conduct or that a particular type of conduct is typically considered by economic theory to indicate the presence of market power, and then to use the fact that a firm has engaged in such conduct to prove market power for the purposes of section 46. The court requires market power to be established as a separate element – for example, by showing evidence as to barriers to entry.

This means that predatory behaviour in a competitive environment designed to raise strategic barriers to entry and create market power cannot be caught by section 46[13]. However, even where there is pre-existing market power, one of the difficulties with predatory behaviour cases is that the conduct typically occurs in response to new entry in an environment that appears to be competitive (at least when looking at a

[12] ACCC Media Release 245/03, 21 November 2003

[13] For discussion of the issues regarding this 'gap' in section 46, see Edwards G, 'The hole in the Section 46 net: The *Boral* Case, recoupment analysis, the problem of predation and what to do about it' (2003) 31 Australian Business Law Review 151.

snapshot in time and narrowly at the price cutting conduct). This creates scope to argue that barriers to entry are not high and that there was no market power at the time of the conduct.

These difficulties are exacerbated by the traditional point to point route market definition commonly used in aviation cases around the world. This raises the issue of leveraging or using market power in one market to obtain market power in another market. For example, assume that airline X has market power in relation to the key Sydney – Melbourne route but the conduct in question is predatory pricing by airline X in relation to a leisure route A – B elsewhere currently serviced by airline X and a low cost carrier Y. Would the conduct be capable of being caught under section 46? Case law suggests it might be difficult to show the requisite nexus, especially if market power in one market creates the financial resources that enable a firm to engage in conduct in another market[14].

The next element that must be established is the legal nexus between the market power and the conduct. In other words, having established that a firm has market power, it is necessary to show that its conduct involved a use of that market power. The courts have approached this issue in a number of ways. For example, it has been said that this means establishing that only a firm with market power could commercially afford to engage in the conduct and that, conversely, if a firm in a competitive market would engage in the conduct or if a commercial business rationale exists, that will indicate that there has been no use of market power[15].

Finally, it must be established the firm used its market power for one of the anti-competitive purposes set out in paragraphs (a) to (c) of section 46(1). In other words, it is not necessary or sufficient to show that the conduct had, or was likely to have, a significant anti-competitive effect.

[14] See for example, the Full Federal Court in Rural Press v ACCC [2002] FCAFC 213 at paragraphs 142 and 146

[15] See for example Queensland Wire v BHP (1989) 167 CLR 177 and Melway v Robert Hicks [2001] HCA 13

When the ACCC investigated the complaints made by Impulse regarding the addition of significant capacity by Qantas on the Newcastle – Brisbane and Newcastle – Melbourne routes in 2000, it reached the view that there did not appear to be any basis for it to take action under section 46 because Qantas could show it had plans to create a regional hub in Newcastle and to commence direct Newcastle – Melbourne services prior to Impulse's service. Further, financial material provided by Qantas appeared to confirm the viability of its capacity expansion consistent with criteria adopted by Qantas in relation to capacity expansion on other routes[16].

These factors suggested that, even if market power could be shown, it would be difficult to establish the requisite nexus between the market power and the conduct and / or any anti-competitive purpose. Without that nexus, even if there had been an anti-competitive effect, the conduct would not be prohibited under section 46.

The ACCC also seemed to be influenced by its conclusion that "there does not appear to be any indication that Impulse has been materially damaged by Qantas' capacity expansion"[17]. This view was echoed in the ACCC's decision three years later to discontinue the action commenced against Qantas in relation to Virgin Blue and the comment by the ACCC Chairman at the time that consumers had benefited from the competition between Qantas and Virgin Blue.

Although the language of section 46 does not require evidence of actual damage to a competitor or to consumers, these matters were considered by the High Court in its key decision on predatory pricing (Boral v ACCC) in 2003[18]. The High Court noted that the target of the alleged predatory conduct had, in fact, survived and suggested that this indicated that the predator did not have market power[19] although the one dissenting judge in the case questioned whether harm could still have occurred via a 'chilling' of competitive conduct[20].

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[16] ACCC Media Release 225/00, 21 August 2000

[17] ACCC Media Release 245/03, 21 November 2003

[18] Boral v ACCC [2003] HCA 5

[19] Boral v ACCC [2003] HCA 5 at paragraph 145-147 (Gleeson CJ and Callinan J)

[20] Boral v ACCC [2003] HCA 5 at paragraph 374 (Kirby J)

The High Court in the Boral case confirmed the view that predatory pricing, at least from an evidentiary perspective, means selling below some measure of cost plus recoupment[21]. However, the High Court also made the point that section 46 does not actually use the phrase 'predatory pricing' and that it would be wrong to allow notions of predatory pricing to put a gloss on the meaning of the section or to allow such a term to "take on a life of its own independent of the statute"[22].

That situation may change if reform proposals put forward in 2004 are adopted. A parliamentary inquiry looking into the effectiveness of the Trade Practices Act in protecting small business recommended that the legislation should provide that in predatory pricing cases the courts may have regard to the capacity of a firm to sell below variable cost and that it should not be necessary to show recoupment[23]. The Federal Government has stated that it agrees with this recommendation only in part. At this stage, it has indicated that it intends to amend the legislation to provide that the courts may have regard to the capacity of a firm to sell below cost (the appropriate measure of cost to be decided by the courts) and also whether the firm has a reasonable prospect or expectation of recoupment, however neither of these are to be essential to a finding that a firm has breached section 46.

In broad terms, the legal position for predatory pricing cases involving aviation in Australia is therefore as follows:

- There is strictly no requirement under section 46 to apply any form of cost test or recoupment requirement. However, if a case is brought as an economic predatory pricing case (that is, it seeks to characterise the impugned conduct as predatory pricing), then it is likely that, from an evidentiary perspective, the courts will look to an appropriate measure of costs and the prospect or expectation of recoupment, although even if these are met it is still necessary to establish the elements of

[21] Boral v ACCC [2003] HCA 5 at paragraphs 130, 191 and 280.

[22] Boral v ACCC [2003] HCA 5 at paragraphs 124, 126 and 128.

[23] Senate Inquiry into the Effectiveness of the Trade Practices Act 1974 in Protecting Small Business, tabled 1 March 2004, recommendation no.3

section 46 in the usual manner. It is therefore appropriate to understand how costs measures and recoupment would be applied in the domestic aviation sector from an economic perspective (as discussed in section 4 below).

- Temporal considerations and market definition will be very important due to the threshold requirement of establishing that the firm has a substantial degree of market power at the time of the relevant conduct and the need to show the nexus between this market power and the relevant conduct. It is therefore appropriate to understand how these would be approached from an economic perspective when looking at the domestic aviation sector.

- Finally, the Australian courts have shown an increasing willingness to have regard to commercial reality rather than relying on theoretical models of behaviour. This may make a difference as to how the courts approach economic evidence as whether pricing conduct by an airline is predatory or merely aggressive competition. Although (as discussed below) economic test often look to fares and costs relating to specific routes, commercial evidence accepted recently by the Australian Competition Tribunal recognised that airlines have different business models and revenue drivers – for example recognising that full service airlines (FSAs) often assess:

> "the profitability and on-going viability of a route on a network-wide basis, having regard not only to the revenue earned on a particular route but also to the revenue earned due to traffic feed in other routes "before" and "beyond" the first-mentioned route. An FSA may operate a loss-making route due to the significance of that route in generating "before" revenue or "beyond' revenue respectively."[24]

4. Economic issues relating to predatory pricing in aviation

Predatory pricing may be defined as a situation where the price is reduced below the level justified by the market in order to cause the exit of an entrant or to tame an

[24] Qantas Airways Limited [2004] ACompT 9 (12 October 2004) at paragraph 84. Interestingly, in this matter, the Tribunal had to consider the impact of an alliance between the two FSAs operating between Australia and New Zealand (with a combined market share of over 80%) constrained by a low cost carrier and a fifth freedom carrier – all of which had different business models and revenue drivers.

aggressive incumbent, with the expectation that once this is accomplished prices will be raised or maintained at supra competitive levels.[25]

Typically, the economic analysis of predatory pricing and its likelihood commences with a specification of the options – accommodating entry or fighting it. Even an incumbent with a substantial degree of market power can and should defend its market position. A pro-competitive response would be to engage in conduct to lower prices by increasing efficiency and/or increase value adding for customers. The problem, however, when attempting to distinguish such a response from anti-competitive predatory conduct is that price cutting may occur in either case and, in the airline industry, more services (increased capacity) may represent increased service/value adding. The issue is how to differentiate between the competitive and the anti-competitive response in practice.

For predation to be rational certain conditions are necessary. First, there must be significant structural and/or strategic barriers to entry into the industry. Otherwise, following exit of this entrant, when the predator raises prices, yet another entrant will appear, again forcing down prices. In the period following deregulation of the airline industry in various parts of the world there was a view that the airline industry was highly contestable – the term 'capital on wings' was used. However, subsequent experience altered this view.[26] Not only were structural barriers high, factors that may enable entry deterring strategic behaviour include:

i. computer reservation system;
ii. commissions paid to travel agents, especially when the rate of the commission relates to the volume of sales;
iii. loyalty programs which raise rivals' costs and increase switching costs for consumers;
iv. government regulation where earlier entry may have been at a time when the regulatory hurdle was lower;

[25] Of course, rather than an increase in nominal price, the benefit may be to allow the quality of the product offering to be reduced while price remains unchanged.

[26] Saverin Borestein, The Evolution of the US Airline Competition, J. of Economic Perspectives, Spring 1992.

v. slot restrictions at airports, incumbent control of access to other services (for example: gate lounges, check-in counters, airbridges, loading baggage) – while the entrant may gain access to these services via a sub lease from the incumbent who has leased the facilities from the airport operator, this may be on less favourable terms.

The difficulty in terms of detecting predation is that successful predation requires the presence of excess capacity otherwise the predator will be unable to hold the market price down. Consequently, either excess capacity must already exist (a barrier to entry) or it must be created as part of the predatory conduct[27]. The standard response of airline businesses around the world to entry, especially entry by low cost carriers, has been to add additional flights, adding further capacity to that added by the entrant.[28] On the other hand, however, arguably the increased service represented by the extra flights may be the only response available to a full service or network airline in the face of competition from an entrant with a much lower cost structure.

cost tests

Economic cost tests assume that an airline would not be expected to continue to supply services on a particular route in the long run unless the revenue generated exceeds average avoidable cost over some relevant time interval[29]. This is the basis

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[27] See the discussion of capacity in Edwards G, 'The Perennial Problem of Predatory Pricing, A Comparison and Appraisal of Predatory Pricing Laws and Recent Predation Cases in the United States and Australia', (2002) 30 Australian Business Law Review 170. While the economic link may be clear, the legal framework may require separate treatment. For example, in the Australian Boral case, the court viewed capacity expansion as a separate matter "which did not play a large part in the case" (Boral v ACCC [2003] HCA 5 at paragraph 149).

[28] Low cost airlines may, of course, 'grow the market' by attracting consumers who would otherwise have chosen a cheaper form of transport (such as bus).

[29] Although it is recognised that there may be legitimate (pro-competitive) reasons why a firm may price below this level (such as to promote its brand name and build a customer base) and conversely there may be circumstances where pricing above this level precludes efficient entry and injures the competitive process – see the discussion in G Edwards, The Perennial Problem of Predatory Pricing, A Comparison and Appraisal of Predatory Pricing Laws and Recent Predation Cases in the United States and Australia, (2002) 30 Australian Business Law Review 170 at pages 182 -186.

for the test of predation proposed by Areeda and Turner[30] applied in the seminal US predatory pricing cases[31], but it gives rise to a number of issues.

First, the question arises as to whose costs are relevant? A relevant measure of the *incumbent's* costs is used as the basis for assessing the price cut. There are two reasons for this. First because it is usually assumed that the incumbent does not know the entrant's costs. Second, because predatory pricing is only really an issue when directed against an equally efficient firm, the implication is that the target firm's costs will be no higher in the long run, for a comparable product, than those of the incumbent, and may be lower (for example due to better technology).

Assume that the target of the predatory pricing is already in the market and that it is efficient, with a cost structure similar to that of the predator, but it is smaller than the predator. Further, assume that the target which had previously been fairly passive has recently had a change of management and is now aggressively pursuing market share through an advertising campaign and product promotion. The predator is starting to lose market share and decides that it is time to show the target what to expect if it continues with its advertising strategy. As the firms' cost structures are known to be similar, to inflict damage on the target the predator will have to cut prices at least below average total cost and so will itself incur losses. This conforms in general terms to the cost test for predatory pricing.

Contrast this with a situation where the target firm is a new entrant. The entrant is assumed to be efficient in the long run. Although the predator only knows its own costs with certainty, it will be able to make a fairly accurate assessment of the entrant's costs from information in the market and from its knowledge of the industry. The entrant's costs, once operating at the planned level of output, may actually be lower than those of the incumbent because its plant and equipment are newer and so

[30] P Areeda and DF Turner, Predatory Pricing and Related Practices under Section 2 of the Sherman Act, 88 Harvard Law Review 697 (1975)

[31] Matsushita v Zenith 106 S Ct 1348 (1986) and Brooke Group v Brown 113 S Ct 2578 (1993), applied in USA v American Airlines 140 F Supp 2d 1141 (D Kan 2001).

incorporate more recent technology[32]. However, the entrant must first get itself established; it must win sales from existing firms which have previously established relationships with their customers. Consequently, initially the entrant will be operating below its target level of output and so its short run costs will be relatively high.

No doubt in assessing the opportunity for successful entry into the market, the entrant assumed that prices would fall below their pre-entry level to reflect increased supply, with demand conditions assumed to be unchanged. However, if the predator lowers prices below this expected level then the entrant's cash and credit reserves to cover the establishment period may be exhausted long before it secures its planned level of sales. Further, financiers who will be aware of any sharp reduction in prices, will be reluctant to risk their capital or will do so only at penalty rates of interest. As the entrant's costs during the establishment period may be higher than those of the incumbent, this will be the period when the entrant is most exposed to attack, and the predator may not need to lower its prices below its own costs in order to damage the entrant.

This suggests that pricing below cost by the alleged predator is a necessary condition for predation where the conduct is directed towards an existing firm with a similar price structure to its own. Further analysis is required in such cases before it can be concluded that the pricing is not predatory. However, it may not be a necessary condition where the target is a new entrant into the market. Of course, if the predator aims to establish a reputation for aggression it is more likely that a very sharp price reduction will occur and this may result in losses.

Next, the time period selected in order to calculate avoidable cost may have a significant influence on the value calculated. The reason why economists typically look at avoidable cost is to assess the rationality (or apparent rationality) of pricing conduct. It is assumed to be irrational to continue to incur costs that cannot be covered by prices and could have been avoided, unless there is some other explanation for doing

[32] or, for example in aviation, because it has been able to negotiate lower cost more flexible labour arrangements while incumbents are stuck with so-called "legacy" costs associated with less flexible work practices.

so. Avoidable costs are those costs which are not incurred if the product is not produced. However,

> 'All costs are variable or avoidable in the sufficiently long run. (…) The fixed costs (like overhead) necessary to make any output this year need not be incurred next year. Generally, even sunk costs are inescapable only for a time. The big expensive plant will eventually wear out and thus require a decision about whether or not to incur the cost of its replacement. … There is thus no cost that is inherently variable, avoidable, fixed, or sunk. It all depends on which time period one uses, whether that period looks backward or forward, and whose output and ability to vary or avoid costs during that period matters.'[33]

Some costs are avoidable because the inputs are purchased more or less as they are used – raw materials, power, distribution services and the like. Other inputs may be owned or may be acquired under contractual arrangements and so even if no output is produced, the cost of these factors will continue to be incurred unless they can be redeployed to some other part of the business or can be sub-contracted. This may take time. Consequently, the extent of avoidable costs depends on the time period necessary to make such arrangements and put them into effect. On the other hand, looking back to the genesis of the conduct being examined (the business decision that set the train of events in motion), it may be that it would have been irrational to incur capital expenditure at that time absent the expectation of a longer term benefit from excluding competitors. Measuring avoidable costs at the time of particular pricing conduct will not reveal this.

This is one area where traditional cost tests can be difficult for courts in the face of direct commercial evidence as to a firm's business plans and strategic objectives – especially given the focus on purpose in section 46.

recoupment

Predation imposes costs on the predator, costs that are likely to be proportionately greater than those experienced by the entrant. If it is not possible to establish that as a result of the predation the predator can reasonably expect to be better off than if it had not engaged in the conduct, it is likely to be difficult to convince a court that the

[33] Einer Elhauge (2003), 'Why above-cost price cuts to drive out entrants are not predatory, and the implications for defining costs and market power', *Yale Law Journal*, vol 112, no 4, p 681-827, at p 707.

conduct was indeed predatory as it would be irrational. Thus, part of the test of whether conduct is predatory is whether or not 'recoupment' is possible:

> 'Recoupment involves the capacity of a firm to price in a manner inconsistent with what a competitive market would dictate in order, at a minimum, *to make good* the losses sustained during a price war.'[34] (emphasis added)

Whether recoupment is possible depends not only on market conditions but also on the time period allowed for 'recoupment', the meaning attached to the term, and the nature of the inter-temporal comparison.

Assume that prior to the predatory pricing there was just one producer and it was maximising its profits and so was charging supra competitive prices. Threatened with entry, the incumbent engaged in predatory pricing, and after a period the entrant exited the market. Following this, the incumbent again raised prices to supra competitive levels. It is arguable that as there is only so much monopoly rent that can be extracted from a market (eventually increasing prices results in such a reduction in sales that revenue and profits are reduced), if the maximum price was being charged pre entry and post exit, then the losses incurred through predation can never be recovered. But this is not the correct comparison. Rather, recoupment occurs because the firm is able to charge monopoly prices in future, whereas absent the predatory conduct it would have received the competitive price – the difference between the two given sufficient time, represents the benefit resulting from the conduct.

Thus, the appropriate consideration in a competition analysis is not whether the predator can recover what predation cost it, but whether the business can *reasonably expect* to benefit/be more profitable at least in the *long run* with the conduct rather than without it. The significance of recoupment is what it reveals about the rationality of the conduct being analysed.

5. The industry post 2001

The demise of Ansett allowed Virgin Blue valuable breathing space to grow until it reached a sufficiently sustainable market position to list on the Australian stock

[34] per Heerey J at first instance in ACCC v Boral [1999] FCA 1318 (paragraph 289).

exchange in December 2003 with a market share of around 25%. Following listing, it continued to attract a growing share of price conscious business travel and to develop a footprint across all major routes that had been serviced by Ansett.

Having reached this scale, it began to raise the prospect of introducing a frequent flyer scheme, business lounges and other additional services traditionally offered by full service airlines. Its costs continued to be low – being 8.16c per ASK[35] for the year ended 31 March 2004 and 7.49c per ASK for the year ended 31 March 2005[36]. Virgin Blue's costs remain the lowest in the country[37] and one of the lowest globally[38].

This should have represented a secure market position, but as illustrated in Attachment 3, its share price movements suggest otherwise. Based on Virgin Blue's most recent financial results (for the 12 months ended 31 May 2005), its current position is a 30% market share but at the cost of profit and earnings per share (both of which are down) and with reduced load factors and yields. Its results refer to non fuel costs being under control but an 'uncertain revenue environment'[39]

In early 2005, with its share price depressed, Virgin Blue was subject to a takeover by its 50% owner Patrick Corporation. The independent expert's report on the offer price referred to a number of factors which contributed to a 'high level of uncertainty for any valuation of Virgin Blue' including the volatility of the airline industry ("The industry is characterised by periods of aggressive, and sometimes irrational, competitive behaviour which can be seriously detrimental to the profitability of all carriers in the relevant market") and the fact that Virgin Blue's current market share of around 33%

[35] 'available seat kilometre', the measure of cost typically referred to by airlines.

[36] Virgin Blue interim results for 6 and 12 months ended 31 March 2005, filed with ASX 18 May 2005.

[37] By comparison, the Australian Competition Tribunal recently referred to the cost per ASK for Qantas' domestic full service operations as being 10.9c – see Qantas Airways Limited [2004] ACompT 9 (12 October 2004) with reasons for decision 16 May 2005 and Jetstar's cost of 8.25c per ASK was referred to in Qantas 03/04 full results presentation to investors 19 August 2004.

[38] See Independent Expert's Report by Grant Samuel & Associates contained in the Target Statement dated 28 February 2005 lodged by Virgin Blue in response to the takeover offer by Patrick Corporation.

[39] Virgin Blue interim results for 6 and 12 months ended 31 March 2005, filed with ASX 18 May 2005

"could vary significantly in the future depending on a range of factors including competitor activity"[40]

Part of the reason for this instability has been the establishment by Qantas of its wholly owned low cost carrier Jetstar in May 2004. Qantas first began talking about establishing its own low cost operator in an announcement to the market in October 2003[41] and from the outset made it clear that it was confident this business would be the lowest cost operator in Australia[42]. A target figure of 7.8c per ASK was indicated[43].

The Jetstar model started off as a very basic 'no frills' operation – bookings by internet only, two types of discount fare only with no frequent flyer points, no business class, lounges, meals or allocated seating, no unaccompanied minors. Not all of these have been successful and Jetstar has since announced the introduction of a full economy fare which generates Qantas frequent flyer points and arrangements have been relaxed to allow Qantas frequent flyers using Jetstar the use of certain Qantas facilities. On the other hand, Jetstar's use of a secondary airport in Melbourne as its base has been successful, and Jetstar has announced that it will look at using secondary airports elsewhere.

The initial phase of Jetstar's operation saw Qantas withdraw Qantas brand full service operations from certain designated 'leisure' destinations now serviced by the Jetstar brand, although market pressure has led to Qantas re-introducing some limited full service Qantas flights to some of these destinations. For example, initially Qantas withdrew all full service Qantas flights from Tasmania (the island to the south of the Australian mainland) but re-introduced two scheduled full service Qantas flights between Melbourne and the Tasmanian capital Hobart after political pressure and the

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[40] See Independent Expert's Report by Grant Samuel & Associates contained in the Target Statement dated 28 February 2005 lodged by Virgin Blue in response to the takeover offer by Patrick Corporation

[41] ASX announcement 16 October 2003

[42] ASX announcement 1 December 2003

[43] Eg see Qantas 03/04 full year results presentation to investors 19 August 2004, which indicated a unit cost of 8.25c per ASK for the first year of operation down to the 7.8c figure when using an all A320 fleet

introduction of additional flights by Virgin Blue aimed at Melbourne – Hobart business travel.

A recent survey of airfares over the past 12 months has indicated that discount economy fares (the price tier below full economy – the bulk of which are bought by price conscious business travellers) have risen by almost 20% in the last year – most markedly on routes where Jetstar does not operate – while leisure fares have apparently remained relatively stable[44].

The use by a full service airline of a low cost subsidiary raises some legal issues (mentioned briefly below) and some economic issues (discussed in section 6 below).

In the context of section 46:

- Can the use of such a low cost subsidiary as a 'fighting brand' (discussed in section 6 below) give the full service parent market power?

- How important is it to ascertain the commercial sustainability of the low cost subsidiary? Does the establishment of a low cost subsidiary that is not commercially sustainable indicate the presence or use of market power. In this regard, it is noted that the High Court has made it clear that having access to material and organisational assets and financial power is not market power[45].

- Conversely, where the full service parent already has market power, under what conditions might there be a nexus between that market power of the parent and the establishment of or conduct by such a low cost subsidiary?

- In what circumstances is it appropriate to consider the combined conduct of the full service parent and the low cost subsidiary?

[44] American Express Asia Pacific second quarter review of business airfares, as reported in the Australian 7 June 2005

[45] Rural Press v ACCC [2003] HCA 75 at paragraph 53.

- If a cost test is to be applied, then whose costs are relevant – the low cost subsidiary, the full service parent or the group as a whole?

- Is it appropriate to apply a cost test (whether to the full service parent or the low cost subsidiary) if the concern is raising the costs of a competitor who would otherwise be a lower cost operator than the incumbent?

6. Strategic behaviour and 'fighting brands'

Strategic behaviour is most likely to occur in oligopolistic markets which comprise a relatively small number of major players, as is generally the case in the airline industry. Firms engage in strategic conduct in order to secure for themselves a long term commercial advantage over their rivals, that is, the conduct is intended to shape the market environment to their advantage. Strategic barriers to entry result from deliberate conduct by an incumbent that is intended to deter entry either directly or by artificially raising structural entry barriers. Alternatively, strategic conduct may be designed to hinder or deter expansion from one market segment to another, that is, it may raise barriers to expansion. Strategic entry deterrence is conduct intended to raise rivals' costs.

Response by incumbent airlines to entry over time reflects both regulatory responses and learning. The Australian experience suggests that in the period immediately after deregulation, incumbents responded strategically based on their ability to limit access to necessary inputs or increase their cost. In addition, early aggressive responses helped establish a reputation for such responses and aggravated the cost asymmetry faced by entrants due to imperfect capital markets. To the extent that regulatory responses removed or blunted the first of these options, the second phase may be a more traditional predatory pricing approach. Should this fail to cause exit, or should further entrants appear, subsequent strategic responses are likely to be more subtle. Such conduct may be designed to undermine the entrants market positioning.

Faced with a cost structure that cannot, at least in any reasonable time frame, be reduced to the level of a low cost airline, the incumbent may choose to introduce its

own lower cost airline (this might be termed a fighting brand).[46] This has the advantage of preserving at least to some extent the full fare structure of its full service parent, and as the market share of the new subsidiary is small, the costs of discounting are considerably less and/or the discounts can be considerably deeper. Further, the reputation of the full service parent is kept largely distinct from that of the low cost subsidiary. As a consequence, the entrant is left in middle territory – it is neither the low cost option, but nor can it offer full service. The likely response is that it will have to move closer to the full service airline and this has the effect of raising the rival's costs thereby depriving it of its cost advantage.

Other possible strategies likely to inflict higher prices on low cost entrants include operating the 'fighting brand' airline out of a secondary airport/s that might otherwise have been used as a lower cost option by entrants.

7. Conclusion

The present legal and economic frameworks used for assessing allegations of predatory pricing in aviation present difficulties when trying to distinguish between competitive and anti-competitive behaviour.

In particular, economic cost tests used in traditional aviation predatory pricing analysis may not necessarily reconcile to direct evidence of 'commercial reality'. However, relying too heavily on an industry view may also raise issues, especially where the evidence is that conduct which would be irrational or unsustainable in a competitive environment is regarded as a "normal" response to new entry.

The Australian domestic aviation sector and the current dynamics within that industry provide an interesting opportunity to consider some of these issues further.

[46] This has the advantage of preserving at least to some extent the full fare structure of its full service parent, and as the market share of the new subsidiary is small, the costs of discounting are considerably less and/or the discounts can be considerably deeper. Further, the reputation of the full service parent is kept largely distinct from that of the low cost subsidiary.

Attachment 1

Map of Australia showing capital cities

Attachment 2

Introduction of access regulation in Australia

In Australia, major airports have traditionally been subject to Federal regulation – as opposed to ports which have come under State control. The Federal Government commenced an airport privatisation program in 1997 – 1998. This was accompanied by transitional price regulation followed by monitoring.

However, deregulation of domestic aviation and the experience of Compass Mark I and II had brought the issue of gaining physical access to attention.

Prior to 1995, Australia did not have national laws specifically providing for access to essential infrastructure. Following an inquiry in the early 1990's, specific national access regulation was introduced in 1995 in the form of Part IIIA of the Trade Practices Act. The model used in Part IIIA essentially gives those unable to negotiate access to "declared" infrastructure the right to seek arbitration by the ACCC. The ACCC has the power to decide terms and conditions of access (including price) in any such arbitration.

Infrastructure is "declared" by an appropriate Federal or State Minister (depending on the type of infrastructure). However, before infrastructure can be "declared" by the relevant Minister, an assessment is required to be made by the National Competition Council as to whether or not certain criteria are met. These criteria include matters such as whether or not access will promote competition in another market[47] and whether or not the infrastructure can be economically duplicated.

In light of the issues that had arisen with access to airports during the time of Compass Mark I and II, and in light of the privatisation of major airports, in 1996 the Federal Government introduced an airport access regime. Basically, this was a streamlined process for bringing certain facilities at key privatised airports under the national access regime. This was done via section 192 of the Airports Act, which

[47] Although this test is the subject of changes currently before parliament (which will alter the test to one of material increase in competition).

allowed the ACCC to determine “airport services” which were essential for airline operations. These “airport services” would then automatically be brought within the national access regime in Part IIIA.

Section 192 of the Airports Act was eventually repealed in 2003, leaving access to airport facilities to be dealt with via declaration under Part IIIA.

However, the airport access regime, in conjunction with the undertakings given by Qantas when it acquired Impulse and the availability of Ansett terminal space following Ansett’s collapse made a significant difference for Virgin Blue’s entry into the market.

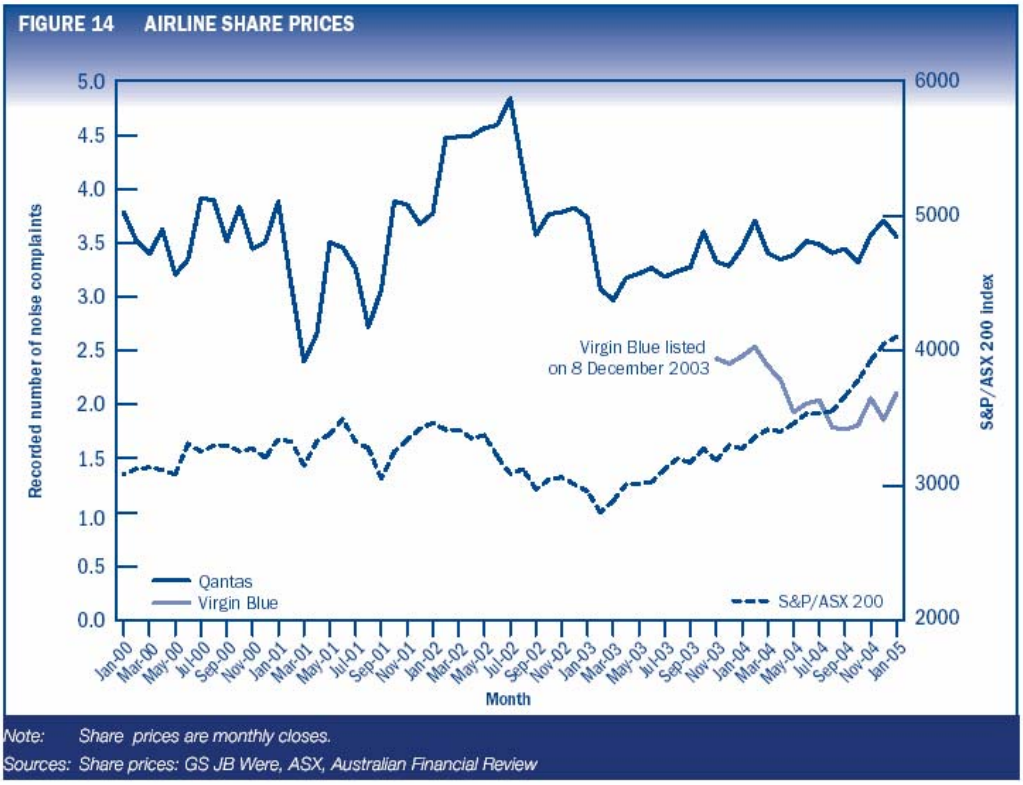
Nevertheless, access issues still occur. In October 2002, Virgin Blue filed an application for declaration under Part IIIA in relation to access to terminal facilities at Sydney airport – but this application was withdrawn in December 2002 after a commercial resolution had been reached with Sydney airport – and earlier this year the regional airline Regional Express had to seek political assistance to overcome difficulties it had experienced in securing on-going access to terminal facilities at Sydney airport.

Attachment 3

From BTRE's Avline, May 2005

Airline share prices

Figure 14 shows the end of month closing prices for Qantas, Virgin Blue and the S&P/ASX 200 Index.



Virgin Blue's share price fell to $1.77 per share in September 2004, 25.6 per cent down on the closing price for the first month of trading in December 2003. By January 2005, the closing price for the month was $2.11 per share, down 13.9 per cent on January 2004.

The Qantas share price reached a high of $3.71 per share in both February and December 2004. In January 2005, Qantas shares closed at $3.56, up 2.9 per cent on January 2004.

Qantas reported a pre-tax profit of $601.3 million for the six months ending 31 December 2004. This was a 13.4 per cent increase over the same period in 2003. The $458.4 million after-tax profit to December 2004 was 28.1 per cent higher than the same period in 2003.

Virgin Blue reported a pre-tax profit of $90 million for the six months ending September 2004. Its after-tax profit for the same period was 63.0 million, down 1.8 per cent on 2003.

Avline 6 May 2005