

MICROECONOMICS AT WORK EXERCISE

COMPETITION IN DOMESTIC CIVIL AVIATION

REFERENCES: ‘Easing of fare war to clip wings of public’ and ‘Corrigan signals end to deep discount air fares’ (by Heath Aston and agencies), *The Courier-Mail*, 4 February 2005, pp. 3 and 31.

CHAPTERS RELEVANT TO THIS EXERCISE: 3 and 11

CONTEXT

The firms that dominate the Australian civil aviation industry are Qantas, Virgin Blue and Jetstar (the latter being wholly owned by Qantas but operated as a separate airline aiming for the lower cost segment of the market). Jetstar was established in the early 2000s to counter the increased share of the total market being gained by Virgin which was competing, successfully, on the basis of lower price. The result has been a ‘discounting war’ between Virgin and Jetstar, which has seen airfares (the price of air travel) fall markedly in the years up to early 2005.

One of the main shareholders of Virgin — Patrick Corporation whose CEO is Chris Corrigan — has recently gained a majority shareholding and thus the power to influence the policy of Virgin. Corrigan has foreshadowed that the discounting war needs to be ended in order to stop the erosion of Virgin’s profits that was occurring as a result of the fare discounting.

QUESTIONS

1. Explain how game theory is applicable to this situation.
2. Explain the comment of Corrigan’s, quoted in the article, that ‘Qantas had effectively surrounded Virgin Blue...’
3. ‘We are always going to be a low-cost alternative... but at the margin we have to change certain things in our business model’ (Corrigan). Would you agree, and why?
4. What are the dangers facing Virgin in what the article suggests will be a ‘retreat’ from its ‘price-slashing battle’.
5. How do you think that the game will be played out in the near future?

ANSWERS

1. Game theory is a framework for analysing the interaction of firms that takes into account the effect of each other's decision making. As it is explained on p. 262 game theory analyses the economic behaviour of an individual firm so as to take 'explicit account of the actions of each and every other player [i.e. firm]' — the 'game' being the maximisation of profit in producing a good or service. In this case the decisions are those of the airline Virgin Blue (specifically in regard to *price*), which are made in the light of decisions made by other firms in the industry, namely Qantas and Jetstar.
2. Virgin Blue, for the first few years of its existence, competed with Qantas at the 'bottom' or discount, low-priced segment (or 'end') of the market (as distinct from the 'upper', higher-priced end – in practice serving mainly the business and government market). By doing so Virgin managed to take a significant share of the 'bottom' end of the market away from Qantas. To counter this competition, Qantas started a separate (but wholly-owned) airline (Jetstar) to compete for this segment of the market by offering low-priced air fares which sought to match or better Virgin's prices. In this way Qantas was able to compete 'from below' as well as 'from above' in terms of the price/quality of service combination that it offered. The more appropriate term might have been 'sandwiched' rather than 'surrounded' but the essential point is that the move left Virgin with no clear direction in which to effectively compete.
3. The statement reflects the view of the effective controller of Virgin business policy that it will continue to compete with Qantas (and any other airline that enters the industry) by providing lower prices and thus seeking to attract business from consumers seeking low-priced fares (particularly from consumers who might be persuaded to travel by air when they haven't done so previously). However, in the light of direct competition now coming from Jetstar, and the effect of increased price competition on the firm's profits, they will have to reconsider the *manner* in which they compete in regard to the price/quality of service combination that they offer and the segment of the air-travelling market they wish to sell their service to.
4. If the changed 'business model' involves a 'retreat' from head-to-head competition with Jetstar in terms of price, Virgin will have to replace price as the principal means of competition with some other means or combination of means — that is, it will have to *differentiate its product* effectively in the eyes of consumers (see pp. 250-5). The 'danger' for Virgin is that it will not be able to do so sufficiently to compensate for losing the recognition of the lowest-cost producer in the industry and in this way lose market share.

5. How all this will be played out (and be reflected in firstly the *market share* and secondly the *profitability* of each airline – and these may not necessarily move in the same direction) will depend on the reaction of Jetstar to a ‘retreat’ by Virgin from discount air fares. Will Jetstar *also* lessen the ferocity of competition in price with the aim of improving its profitability (*tacit collusion* – see p. 263) or will it continue to set its prices below Virgin in order to clearly establish its position as the lowest-cost airline? By stopping trying to undercut Jetstar will Virgin be able to differentiate its product to the extent necessary to maintain its market share and at the same time improve its profitability? Will Virgin turn in part to competition with respect other segments of the market (devote some of its forces to fighting the war on another front) by, for example, attempting to gain some of the business and government market by improving the quality of its product (in respect to, say, seating or terminal facilities)? The manner in which the game is played will depend on strategies adopted in these and other respects.