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Australian air freight cartel case crashes

Why did the New Zealand and Australian courts differ?

In two high court decisions prosecuting airlines for colluding to fix fuel surcharges on routes to New Zealand and Australia, the respective courts came to very different decisions based on the same arguments. In *Commerce Commission v Air New Zealand* (2011) 9 NZBLC 103 the New Zealand High court held that inbound air freight was a market in New Zealand. In *ACCC v Air New Zealand* [2014] FCA 1157 Perram J concluded:

> [20] The evidence showed that the surcharges were imposed and collected at the origin airports. The competition which occurred between the airlines and which the surcharges interfered with was competition in markets in Hong Kong, Singapore and Indonesia and not competition in any market in Australia. Prices may well have been affected in Australia by the conduct but that does not mean the market in which the airlines were competing was located here.

The prosecutions' case

The cases concerned cargo carried on scheduled passenger aircraft (which raised complications not adequately resolved in either decision). All sides agreed that from a demand-side perspective inbound air cargo services was a separate market from outbound air cargo services (cargo does not travel on a return ticket with the exception of racehorses!). The airlines pleaded that the geographic market was the airport/country of origin, and therefore not a market in Australia or New Zealand. The ACCC and Commerce Commission pleaded that the inbound market was "in part" in Australia or New Zealand because: inbound aircraft flew across, landed and unloaded in Australia or New Zealand; that "on occasions" importers were involved in the decision over inbound freight services; the demand for airfreight was derived from that of importers; and air freight charges affected prices in Australia or New Zealand. The New Zealand court was persuaded by these factors; the Australian court unimpressed.

A key proposition was that demand for air freight services was a derived from the value of imports carried by air, or as Perram J termed it "downstream substitution". According to the ACCC and Commerce Commission, this meant that the geographic market included the location of importers as they were the ultimate consumers of inbound air freight services; and that origin freight forwarding, airline cargo services, ground handling and other services at the destination airports, and importing were all in the same single product market.

In the New Zealand proceeding one of the Commerce Commission's expert economists ([177]) said in cross-examination, which was cited favourably by the court, that in assessing a 10% SSNIP for inbound freight "the reaction of the importer to the price increase matters, it matters to market definition, and it matters to substitutability". He also said "It all depends – it's a matter of degree, like so many things in economics. It all depends on the degree of closeness or remoteness between the supplier and the direct and indirect customer".

The derived demand proposition cut no ice with the Australian judge. He observed that it confused the demand for the imported product with the demand for its carriage; and more importantly failed to show how the decisions of importers in Australia constrained the price of air freight services in Hong Kong or Jakarta. In both cases, but fatally in the Australian case, there was a "complete absence of any evidence". Perram J concluded:

> [320] I am left with what was described by the parties as a thought experiment. A thought experiment clarifies concepts but it cannot provide a substitution for some empirical evidence be it qualitative or quantitative. There is simply no basis upon which I could find this effect did, or was likely to, take place.

Exploring derived demand

The concept of derived demand is simple - the demand for an input or intermediate service is derived from the value of the final product it produces. A steel girder is valued not for itself but for its use in construction. This can be found in any economics textbook. But the same textbooks note two crucial factors regarding derived demand - the demand elasticity of the final good; and the ratio of input to total costs.

Thus the first question that must be addressed is - Did Australian or New Zealand importers have a large or limited choice of substitute imports which could have been transported by air from different locations (the distance to Australia rules out sea, road and rail as close substitutes)? If they did, the import elasticity was high; if they didn't, the import elasticity was low.

The second, and more critical, factor serves to reduce the demand elasticity for air freight for any given import elasticity. The lower the ratio of airfreight costs to import

value, the less significant is the role of importer substitution. To illustrate, if the import elasticity is -2.0 and air freight costs 3% of the FOB value of imports, then the air freight elasticity of demand would be less at .03 x -2.0 = -0.06, which is highly inelastic. Thus looking at the importers' substitution possibilities alone tells us little.

Some real evidence

So is importer demand likely to be a useful consideration in defining inbound air freight markets. The answer based on the evidence is no.

First, research (Menon, 1993) shows that the import elasticity of the goods most frequently air freighted into Australia is low - medical, pharmaceutical products at -0.50; essential oil and perfumes at -0.28; photographic and optical goods at -0.36; power generating machinery at -1.06; specialised machinery at -0.40; general industrial machinery at -0.96 and electrical machinery and parts at -0.41. Admittedly these elasticities are overall and not route-specific ones, but there are good reasons to believe that many route-specific elasticities are similarly low. Documentary evidence in the New Zealand proceeding showed that importers often do not have much choice since imports had to be sourced from specific production plants or distributors. For many larger importers direct flights and reliability were more important than air freight charges. The growth of "just in time" (JIT) inventory management where firms and distributors minimise their inventories by flying in parts and components as and when required to meet customer demand has greatly heightened this.

Second, the ratio of air freight costs to the FOB value of imported goods flown into Australia (and New Zealand) is low. Imports from Hong Kong and Singapore are high value to weight goods such as machines, electronics, cameras, spectacles, jewellery, pharmaceuticals and so on. Using data from one airline's Air Waybills for the top imports that can be matched to the Australian Bureau of Statistics Maritrade data, confirms that the air freight costs to import value ratios are about 6.2% for engines, 2.5% for cameras, and 1.5% for flowers. One of the largest importers of electronic goods stated that its air freight costs were only 3% of the FOB value.

If one were to take these figures the derived demand for inbound air freight services would appear very inelastic at -0.03 (assuming an air freight costs ratio of 3% and import elasticity of -1.0). Put more tellingly, a 10% SSNIP of inbound air freight rates would raise importers' costs by a mere 0.003% assuming they were fully passed on. Note that these calculations are purely illustrative and ignore that airline freight charges are often only a proportion of the inbound freight forwarders' charges (they vary from 30% to 95%), and the other significant costs of getting their goods to and from the origin and destination airports, and warehousing them faced by importers.

Thus the importers' reaction to a SSNIP is unlikely to "matter" despite the ACCC and Commerce Commission's witnesses' impressionistic statements to the contrary. And, paradoxically, it is specifically because the demand for inbound air freight is a derived demand that the substitution opportunities open to importers are unlikely to place a significant constraint on inbound air freight rates.

The role of agreed statement of facts

There were also interesting differences in the way the two cases were run which appeared to have affected their outcomes. In the New Zealand case the Commerce Commission and airlines worked together on an agreed statement of facts; and the proceeding was split into two trials – the first on geographic market definition; the second on liability. In the Australian proceeding Air New Zealand refused to join the other airlines in drafting an agreed statement of facts with the ACCC. The latter settled before the trial incurring fines of around $100m while Air New Zealand went on to win its case. Perram J [334] ignored the New Zealand decision on the ground that the "agreed statement of facts" meant that it did not consider downstream substitution. This is not correct; agreed facts or not, the New Zealand court heard extensive evidence on all the issues Perram J considered.

Conclusion

Using easily marshalled evidence it has been shown that derived demand was not a relevant consideration in defining the geographic market for inbound air freight. Second, in future cartel cases defendants are unlikely to rush to agree the facts with the regulator.

Cento Veljanovski was expert for the airlines in the New Zealand case, and advised Air New Zealand in the Australian case.

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For further information or to discuss a specific assignment contact:

Dr Cento Veljanovski +44 (0) 20 7376 4418 or cento@casecon.com