

Competition in the airline industry: The case of price war between Malaysia Airlines and AirAsia

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Abstract

Malaysia Airlines in the month of May 2008 launched its zero-fare campaign for local as well as for Southeast Asia destinations. AirAsia claimed that Malaysia Airlines is cross-subsidising the zero-fare campaign with profits from international routes. In addition, Malaysia Airlines is accused of practicing predatory pricing. There is a simple test for cross subsidy and predatory pricing. The simple test for cross subsidy is the cost approach. If the revenue from a subset of outputs is less than its incremental cost, the subset is the receiver of cross subsidy. The test for predatory pricing is that any price below variable cost is predatory if it can prove that the price constitutes a threat to an efficient firm. In addition, it must be shown that the predator tries to eliminate its competitors. Once the competitors exit the market, it must also be shown that the predator firm raises the price to recoup the losses suffered in price wars. In this price war, there is no evidence of cross subsidy. Similarly, the Malaysia Airlines aggressive pricing is not predatory.

Key words: Cross subsidy, predatory pricing, incremental cost, variable cost, stand-alone cost.

Introduction

Malaysia Airlines denied the accusation by AirAsia that it was using international subsidies to finance its “Everyday Low Fares” campaign (New Straits Times, 16 May 2008a), as it launched its zero-fare campaign for local as well as for Southeast Asia destinations in May 2008. There are accusations made against Malaysia Airlines that it is practicing predatory pricing.

The aim of this paper is to clarify the issues that have been raised in the debate: first, the claim that Malaysia Airlines is cross-subsidising the zero-fare campaign and second, the aggressive pricing by Malaysia Airlines, which has been branded as predatory.

The structure of the paper is as follows. First, it reviews the management accounting tools that help in the analysis of the issues in this price competition. The concepts of these tools are very important because there exist differences in the way costs are defined, and it is usually easier to define cost concepts than it is to quantify these costs. The diagnostic tools are stand-alone cost (SAC), incremental cost (IC), and variable cost (VC).

Second, it discusses the analytical constructs that are relevant to the analysis of the issues. The term ‘analytical construct’ has been invented to describe the issues discussed in this

paper in a way which is as linguistically neutral as possible. This is because predatory pricing has negative connotations. These analytical constructs can help establish which facts are relevant that will shed light on particular issues in this price competition. This paper considers the analytical constructs on cross subsidy and predatory pricing. It defines each of the constructs; discusses the motivation for their adoption by those involved; assesses their consequences; and briefly considers the tests for the constructs.

Third, the backgrounds of the corporations are discussed. The data collection for the case is taken from newspaper articles in the public domain published by The Star, The New Straits Times, and data obtained from Malaysia Airlines and AirAsia websites. Finally, a discussion on the issues concludes this paper.

Management Accounting Tools

Stand-Alone Cost (SAC)

Baumol defined SAC (1986, pp. 120-121) as:

The stand alone cost of serving any buyer or a group of buyers whose bundle of purchases is the vector, y , is the total cost that would be incurred if the suppliers of y were to produce it without simultaneously producing any other items or any additional quantities of any of the commodities included in y .

In other words, SAC is the hypothetical cost of producing any individual output or any conceivable combination of outputs if its production were deprived of all economies of scale and economies of scope - the cost savings derived from complementarities with the production of other goods in the supplier's product lines.

The argument is that no buyer or groups of buyers of a product or a combination of products supplied by a firm should pay more than the SAC of those purchases. According to Baumol (1986, p. 121),

The logic of this criterion, of course, is that any group that receives the vector y in return for a payment, $p_y y$, that is no greater than its stand alone cost must not be harmed and may be benefiting from the fact that the supplier is serving other customers in addition to themselves.

The benefit derived from this association will offer no incentive to the group to obtain the products from other suppliers. In addition, the SAC concept offers consumers the protection against excessive pricing through the forces of competition. In the absence of barriers to competition, provision of a product at a price above SAC means that an alternative supplier would emerge to provide at SAC. However, Baumol (1986, p. 121) cautioned that:

... competition forces a reduction in the prices of any combination of goods if and only if they can be supplied more cheaply by an entrant, that is, if and only if the prices exceed the corresponding stand alone cost.

According to Baumol (1986), the SAC concept should ensure equitable utility pricing, particularly when a number of economists have turned to this concept as a defensible ceiling for pricing.

Incremental Cost (IC)

IC can be defined as the increase in cost as a result of producing a further output in addition to the existing output. Mathematically, IC of product y_2 is defined as $C(y_1, y_2) -$

$C(y_1, 0)$ where $C(\cdot)$ is the total cost function. The argument is that the price of product 1 which exceeds its IC is not 'unfair' to the buyers of product 2 since those buyers gain from the sale of product 1 at that price. Baumol (1986) considered that the consumers of product 1 are better off by the supply of that product. This is because consumers of the firm's other products must also gain as a group, and no consumers lose out in the process. The definition of which output is the first one for a firm that produces two outputs may be of crucial significance because the first output bears all the common costs. There is no limit to the number of outputs which have to be considered, and this raises the issue of ordering (Heald 1996). For example, Aumann-Shapley prices are based on marginal costs averaged along a linear path from zero to current production, and Shapley prices are based on incremental costs averaged over all possible orderings of outputs (Curien 1991, p. 82).

Variable Cost

According to Clark (1923), variable cost means a number of 'accounting items' that vary in proportion to variations in business. In more general terms, it is a cost that varies with the level of output. The variation of cost is made with reference to the fluctuation of production in a short period of time. In the long run, all costs are variable. There are various terms for variable cost. Marshall (1916, p. 359) called it 'special, direct or prime cost'. His 'special cost' included the cost of raw material used, the wages of the part of labour spent which is paid by the hour or by piece, and the wear and tear of the plant used in producing the commodity. This special cost is the lowest price that an entrepreneur can accept in time of excess capacity or when trade is slack. Marshall stated that, in normal circumstances, prices must be above prime cost.

Analytical Constructs

Cross Subsidy

Definition

Viscusi et al. (1995) have provided a simple definition of cross subsidy. Cross subsidisation

... is the use of revenue from the sale of one product to subsidize the sale of another product. More specifically, the price of one product is set to exceed its average cost while the price of a second product is set below its average cost (Viscusi et al. 1995, p. 337)

Another general definition of cross-subsidisation is provided by the EU Commission's guidelines on the application of competition rules in the telecommunications sector as follows:

Cross-subsidisation means that an undertaking allocates all or parts of the costs of its activity in one product or geographic market to its activity in another product or geographic market.¹

¹Official Journal of the European Communities (1991). Guidelines on the Application of EEC Competition Rules in the Telecommunications Sector, C233, Volume 34 (6 September 1991): 91/C233/20.

Motivation for Cross Subsidy

There are many motives for cross subsidisation. First, it has been used in a benevolent way by making essential but uneconomic services affordable to all. This is consistent with the 1948 United Nation's Declaration of Human Rights; five out of thirty articles relate to economic rights and recognise that every individual has a right to a minimum level of economic necessities, for example adequate food, shelter, heat, clothing, healthcare and education (Zajac 1996).

Second, cross subsidy has been defended in the past by governments as necessary in order to finance development of national infrastructure. This can be illustrated by the expanding and widespread availability of telephone services throughout the 20th century that has benefited society and contributed to economic development and growth (Cronin et al. 1995, 1997). Kaserman et al. (1990) remarked that the telecommunications industry has been subjected to many varieties of cross subsidisation.

Posner (1971) argued that cross subsidisation can be used by government as a policy instrument to redistribute wealth from one group of consumers to another. Posner was of the opinion that cross subsidy is an aspect of public finance that can be used to redistribute wealth. The state can use this 'tax mechanism' to extract money from its subjects in order:

- a) to defray the cost of services that the politically dominant elements of the state wish to provide and that the market would not provide in the desired quantity and at the desired price, or
- b) to transfer money from one group to another, or
- c) often, to do both (pp. 28-29).

Posner stated that regulation is in part a system of taxation or public finance, particularly in the use of cross subsidisation. An example is a uniform price for a local telephone service, which enables a consumer who lives in a rural area to pay the same fee as a consumer who lives in a city, even though the costs of installing the telephone for the rural consumer are much higher than the cost of installation for the city consumer. Posner concluded that:

Internal subsidization may thus be viewed as an exertion of state power whose purpose, like that of other taxes, is to compel members of the public to support a service that the market would provide at a reduced level, or not all. It is in fact a form of excise tax, with the burden falling on purchasers of certain goods or services, and the proceeds earmarked for specific uses (p. 29).

Recently, Laffont (1999) argued that cross subsidy can help finance the provision of universal service in developing countries. He considered that cross subsidy tends to be a more efficient way of financing these services than tax because the latter is more

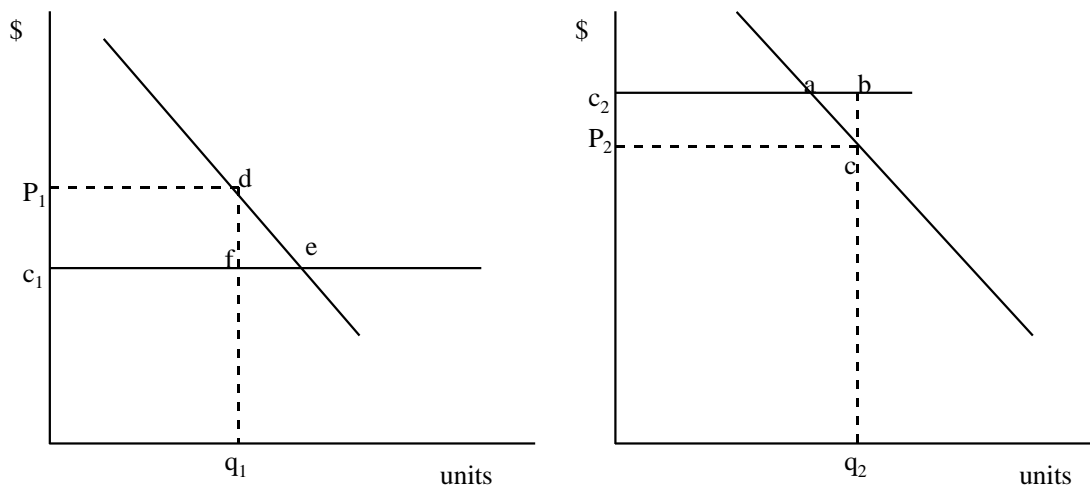
expensive. He remarked that it costs between 0.3 and 0.5 to raise a unit of public funds in most developed countries. In developing countries, the costs are much higher, as demonstrated by Thailand (1.19 to 1.54), Malaysia (1.20) and Philippines (2.48). However, Schmalensee (1999) was more cautious in commenting on the way to finance universal services in developing countries. Although in theory it is better to finance these services with cross subsidy in the absence of an efficient tax system, he argued that once the decision to rely on this for financing is made, it may be difficult to reverse when the tax system improves.

The third motive of cross subsidy is to gain ‘unfair’ advantages over competitors. Cross subsidy has been used by dominant firms in ‘unfair’ pricing decisions. A business undertaking uses cross subsidy as an investment to minimise the impact of competition in a market. According to Heald (1997), Stagecoach ran free buses on small competitors’ routes, and Associated Newspapers temporarily revived an old title to force out a competitor from the lucrative London evening newspaper market. In addition to unfair pricing, the producers of a monopolised output in favouring their own associated companies for a choice of suppliers in competitive supplies markets, may utilise cross subsidy which later can be fed through as costs into the regulated market, thus earning abnormal profit (Heald 1994).

Consequences of Cross Subsidy

Figure 1

The effect of cross subsidisation on economic efficiency



Source: Viscusi, W. K., J. M. Vernon and J. E. Harrington (1995). *Economics of Regulation and Antitrust*, 2nd Edition, Cambridge, Massachusetts, MIT Press, p. 533.

The practice of cross subsidizing is damaging to economic efficiency. Viscusi et al. (1995) provided an example shown in Figure 1. A regulated firm produces products 1 and 2. It assumes that the demands for both products are independent. ‘For whatever reason’,

the regulatory authority wants to increase the supply of the high-cost product, product 2. The price of product 2 is set at P_2 where $P_2 < c_2$, and c_2 is the unit cost of product 2. The effect of such a pricing policy is a loss to the firm as represented by c_2acP_2 and welfare loss (abc). If the firm is to earn normal profits, the regulatory authority must increase the price of product 1 to P_1 ; mathematically, this can be shown as $(P_1 - c_1)q_1 + (P_2 - c_2)q_2 = 0$. The welfare loss of the pricing policy designed to subsidise the supply of product 2 is the sum of abc and def. Triangle abc represents the resources consumed by product 2 that have not been used efficiently. The policy of cross subsidisation entails the spread of deadweight losses to other markets as shown by the triangle def in the product 1 market.

Test for Cross Subsidy

There is a belief that a price that is set below cost constitutes cross subsidy. However, there is no consensus with respect to the definition of which costs are relevant to compare with price (Faulhaber 1979). There are, according to Faulhaber, two tests that can be used to determine whether a particular rate is 'subsidy free' or not. These are rate comparison tests and cost tests. A rate comparison test is a test which compares the costs of 'similar' services with the costs of the service in question, and the rates for the 'similar' services are themselves subsidy free. A cost test is a test to establish whether the revenue from a particular product is at least equal to the defined cost of producing the product. If the revenue received equals or exceeds the appropriately defined cost of producing the amount of good in question, then the product is subsidy free. If, however, the revenue received does not cover its cost, then it is not subsidy free. What is critical here is the definition of cost, especially in the presence of economies of scale and economies of scope. The cost approaches used by various agencies at various times were IC and fully distributed cost (Faulhaber 1979).

In order to provide for a better definition of costs for a cross subsidy test, Faulhaber (1975) suggested some tests. A subset j of outputs is the source of cross subsidy if the revenue from that subset exceeds the SAC. This can be presented mathematically as:

$$q_j \cdot p_j \geq c(q_j)$$

If a firm, besides producing a subset of j outputs, also produces a complementary subset of $n-j$ outputs, a subset of j outputs is the receiver of cross subsidy if the revenue from that subset is less than its IC, and this is mathematically presented as

$$q_j \cdot p_j \leq c(q_n) - c(q_{n-j})$$

Predatory Pricing

Definition

Sheffett (1994, pp. 163-164) defined predatory pricing as:

... when a firm sets a price for its product that is below some measure of cost and forfeits revenue in the short run to put competitors out of business. Once the targeted competitors have been eliminated, the alleged predator then raises its price to a high "supracompetitive" level and makes exorbitant profits to "recoup" the previously lost revenue.

The US Supreme Court defined predatory pricing as:

... pricing below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run (as reported by American Bar Association, Antitrust Section 1992a, p. 227).

Joskow and Klevorick (1979, p. 213) defined predatory pricing as follows:

Predatory pricing behaviour involves a reduction of price in the short run so as to drive competing firms out of the market or to discourage entry of new firms in an effort to gain larger profits via higher prices in the long run than would have been earned if the price reduction had not occurred.

Areeda and Turner (1975) defined predation as a deliberate sacrifice of present revenues for the purpose of eliminating competitors from the market and then recouping the losses via higher profits earned in the absence of competition. Areeda and Turner did not mention predatory pricing explicitly in the above definition. However, on page 697 of their article, they mentioned that a firm which drives out or excludes competitors by selling at unremunerative prices and not competing on merit, is displaying predation.

Based on the above definitions, predatory pricing can be defined as unremunerative prices set by a firm in the short term that are below an 'acceptable measure' of cost in order to eliminate and deter competitors, and in the long term the firm is able to recoup previous losses and gain higher profits via higher prices.

Motivation for Predatory Pricing

There are many motives for predatory pricing. First, it has been used to gain market share (Gundlach 1995). Faced with declining market growth, the proliferation of new technologies and resource scarcities, a firm devises competition-centred strategies that include the manipulation of prices to increase profits at the expense of rivals through market share growth rather than market growth. Standard Oil used local price cuts to obtain market dominance (McGee 1958). Competitive strategies that weaken or destroy rivals, such as price cuts to below marginal or average variable costs, price discrimination, and a temporary price war can enable the firm to wrest market share from its rivals. Once the rivals are defeated, the market value of their assets falls and the predator will find it cheaper to buy the firms, thus eliminating the rivals from the market.

A study by Burns (1986) lends considerable support to the view that predatory pricing can improve the terms of a take-over. Burns studied the activities of American Tobacco from 1891 to 1906. During that period, it had acquired 43 rival companies. Burns found that the alleged predation produced a significant cost reduction to American Tobacco. The benefits gained from predatory pricing can be more than the reduction of profits during the price wars.

Second, predatory pricing can enhance the incumbent's reputation. This can be done by simply concentrating on a particular aspect of profitability that can drive rivals out of the markets. This is invaluable as it might have an effect on future entry. A policy of preserving monopoly by the incumbent can be inferred from those actions. Yamey (1972) gave an example. When negotiating the purchase price for a rival firm, the monopolist, when forcing the price down, is looking beyond the immediate problem of dealing with

that rival. Kreps and Wilson (1982) showed that, with incomplete and asymmetrically distributed information, and if rivals perceive that an incumbent firm has a taste for rapacious action, then that firm's optimal strategy is to employ it in all but a few encounters. For the incumbent firm, predation is a worthwhile investment to sustain or enhance its reputation to deter entry.

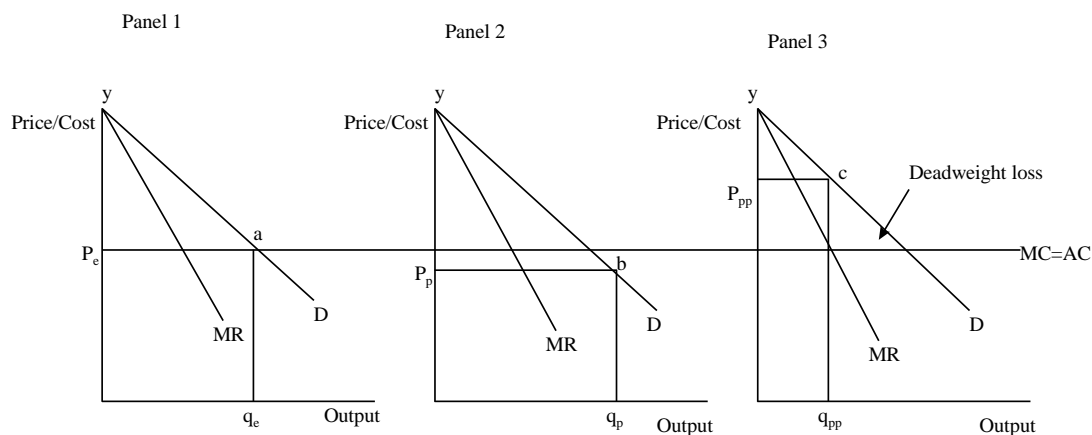
Third, predatory pricing may also be used to discipline rivals, or prevent their expansion or advancement in the market, rather than to cause their exit (Telser 1966, Nalebuff and Brandenburger 1996). Bolton and Scharfstein (1990) argued that the termination threat to some firms with financial constraints provided an incentive to the incumbent to ensure that entrants or rivals with less financial backing perform badly. This increases the probability that investors will cut off funding and induce their exit. In another study, Morton (1997) found that predatory pricing had been used to prey on new and weak entrants which had fewer financial resources, less experience and poor trading conditions.

Fourth, predatory pricing has been used to deter potential entrants. Facing a threat of competitive entry by a new technology, an incumbent monopolist supplying an old technology may take a strategic action that can exploit the installed-base effect by way of predatory pricing (Farrell and Saloner 1986). This is done by deploying a temporary price cut to keep competition at bay until the incumbent's technology regains parity. In addition, the incumbent monopolist can also use 'predatory pre-announcement' (or premature announcement) which is an announcement of the future availability of a new product. The purpose of predatory pre-announcement is to discourage existing customers from switching to competitors, and to encourage those intending to buy soon to wait for the availability of the new product.

Consequences of Predatory Pricing

Figure 2

The effect of predatory pricing



Source: Adapted from George, K. D., C. Joll and E. L. Lynk (1991). *Industrial Organisation*, 4th Edition, London, Routledge, p. 168.

The practice of predatory pricing does not promote fair market competition, economic welfare or economic efficiency. Consider a simple example as shown in Figure 2. In a perfectly competitive market, a firm will produce output q_e at a unit price of P_e (panel 1). At that price the total consumer surplus is shown by the area $yP_e a$. When a firm practises predatory pricing, it will produce output q_p at a price of P_p per unit (panel 2). The total consumer surplus is shown by the area $yP_p b$. The reduction in price from P_e to P_p has resulted in an increase in total consumer surplus. However, the lower price is only temporary, as its objective is to drive out rivals from the market; equally efficient rivals who have a shallow pocket might be destroyed in the process of competing with the predator firm. In other words, they are not competing with the incumbent firm on a 'fair' basis as the incumbent has a long purse or has the ability to make up for the resulting deficiency in earnings by charging excessive prices for its monopoly products. The price cut to below costs implies that the resources have not been used efficiently as the costs are greater than the revenue; society would be better off in the absence of this practice in the long run. Once the rivals have exited, the firm will increase the price to P_{pp} and will only produce q_{pp} output (panel 3). The total consumer surplus at that price is shown by the area $yP_{pp} c$; a reduction of total consumer surplus as compared to the other two scenarios. The resulting loss in consumer surplus as shown by the deadweight loss also represents a loss to society if the equipment used by the rivals that have exited cannot be put to alternative uses, due to its specificity.

Test for Predatory Pricing

The debates on the predatory pricing test have shown that finding a cost measurement technique that can be used in the test is problematic, particularly when a significant part of the costs is fixed and possibly sunk (see, for example, Scherer 1976a; 1976b Williamson 1977; 1978; 1979 and Ordover and Saloner 1989). Until now, there is no consensus on the appropriate test for predatory pricing, though many courts in the United States have adapted the basic principles of the Areeda-Turner test (Hovenkamp 1994).

The Areeda-Turner test has never considered the alleged predator's intent. The courts in the United States have, according to Hovenkamp, responded by modifying the rule. Hovenkamp cited a court's view that a price below average variable cost creates a rebuttable presumption of predation. A price which is above average variable cost but below average total cost creates a rebuttable presumption of non-predation. On the other hand, a price which is above average total cost is not conclusively legal, as it would be under the Areeda-Turner test. The court will consider the evidence of predatory intent and market structure in determining whether those assumptions can be defeated.

The affected parties

AirAsia²

Tune Air Sdn Bhd acquired the equity in AirAsia from DRB-Hicom in late 2001, and became Malaysia's second national airline. AirAsia became the first low fare, ticket less airline in Asia. It offers a simple "no frills" service at fares that are on average significantly lower than those offered by normal full-service airlines. The model was

² The information is obtained from <http://www.airasia.com/>

based on the successful airlines of the US-based Southwest Airlines and the Dublin-based Ryanair.

Since AirAsia introduced its low fare and no frills concept, the airline now flies to various destinations in Malaysia, Thailand, Indonesia, Singapore, China, Philippines, Brunei, Cambodia, Laos, Vietnam and Myanmar. AirAsia formed two successful joint ventures in Thailand (Thai AirAsia), and in Indonesia (Indonesia AirAsia). It has now carried over 35 million passengers. The success has attracted investments from IDB Infrastructure Fund L.P., Crescent Venture Partners and Deucalion Capital II Limited who have acquired equity in AirAsia Sdn Bhd worth US\$26 million (RM98.80 million).

In order to promote low cost air travel, The Malaysian government has built a dedicated terminal for low cost air carrier operations. The low cost terminal is designed to cater for 10 million passengers per annum which later can be expanded to 15 million passengers if required, with 30 parking bays for aircrafts. This terminal provides AirAsia with numerous cost saving opportunities as well as a more efficient operation.

The fundamental concept of running a low fare carrier is the ability to manage a very low cost of operation. First, AirAsia operates on a non-ticket service that saved the airline about US\$1 for each ticket. Second, it offers no meal or other services. Instead the airline sells meals and snacks to the passengers. Third, AirAsia works through supply chain management to get its supply-part inventory. It has a strategic alliance with GE Engine Services Malaysia Sdn Bhd and Airline Rotables Limited. Fourth, it cuts unnecessary cost through not offering any connection flights and trains pilots to save fuels. In addition, the airline does not offer onboard entertainments, which consume fuels and their maintenance is high. Fifth, the airline operates only one type of aircraft. In line with its growth and expansion plans, AirAsia has ordered 175 A320 aircrafts from Airbus. This order will make AirAsia the single largest customer for the aircraft in Asia-Pacific. The new aircraft would gradually replaced AirAsia's existing Boeing 737-300s.

Malaysia Airlines³

Malaysia Airlines had its humble beginning in the golden age of travel in the colonial days. A team from the Ocean Steamship Company of Liverpool, the Straits Steamship of Singapore and Imperial Airways proposed to the government of the Colonial Straits Settlement to run an air service between Penang and Singapore. As a result, Malayan Airways Limited (MAL) was incorporated in 1937. In early 1947, MAL took to the skies with its first commercial flight. When Malaysia was formed in 1963, the airline changed its name to Malaysian Airlines Limited and soon after, Borneo Airways was incorporated into MAL. In the space of twenty years, MAL had grown from a single aircraft operator into a company with 2,400 employees and a fleet operator using the then latest Comet IV jet aircraft, six F27s, eight DCs and two Pioneers.

When Singapore separated from Malaysia in 1965, MAL became a bi-national airline and was renamed Malaysia-Singapore Airlines (MSA). The airline grew exponentially with new services to Perth, Taipei, Rome and London. In 1973, the partners went separate ways with Malaysia introduced Malaysian Airline Limited, which subsequently was renamed Malaysian Airline System, or simply known as Malaysia Airlines, and

³ The information is obtained from <http://www.malaysiaairlines.com/>.

Singapore with Singapore Airlines. Today, Malaysia Airlines flies nearly 50,000 passengers daily to some 100 destinations worldwide.

In the early 2000s, the Malaysian government had to bail out Malaysia Airlines due to a poor management and the effect of Asian financial crisis where the value of Ringgit was devalued by 50 per cent. The Ringgit was later pegged at RM3.80 per US\$1. A Task Force was set up to turnaround Malaysia Airlines. However, in 2005, Malaysia Airlines again suffered a financial loss of over RM1.3 billions. In early 2006, the new appointed managing director and his management team announced a business turnaround plan (BTP) with a mission to become a profitable airline, to cut losses from RM1.7 billion (full year) to RM620 million in 2006, to achieve a profit of RM50 million and a record profit of RM500 million in 2007 and 2008 respectively. The thrust of the BTP was flying to win customers, mastering operational excellence, financing and aligning business on profitability, unleashing talents and capabilities, and lastly winning coalitions.

Having achieved a record profit of RM610 million in 2006, a new business turnaround plan was executed that focused on profitable growth in the face of big challenges in the airline industry including overcapacity, intense competition with yields and profit margins eroding, liberalisation of ASEAN skies and rising fuel costs. Under the new business turnaround plan, Malaysia Airlines' vision is to become the World's Five Star Value Carrier with a mission to be consistently profitable. In order to achieve this mission, it has adopted five business strategies (5-star products and services, lower costs, competitive fares, get more customers and more revenue, and, grow network and build capacity).

Discussion and conclusion

Rocketing fuel prices have forced the airline industry players to take drastic measures to ensure that they pull through the difficult times. Malaysia Airlines implemented a new business strategy that blended the full-service carrier traits with that of low-cost carriers (New Straits Times, 5 June 2008). According to Idris Jala of Malaysia Airlines, the "Everyday Low Fares" campaign has created a new market for the airline. In addition cost cutting measures such as the introduction of meal boxes for the economy class passengers are implemented to remain competitive and sustainable.

However, AirAsia accused Malaysia Airlines of practicing cross subsidisation to fund its "Everyday Low Fares" campaign (The Star, 17 May 2008). Malaysia Airlines has on the average sold 70 per cent of the seats. The 70 per cent seats sold gives Malaysia Airlines its normal profit. Without effective business strategy, the other 30 per cent unsold seats will reduce profit, and Malaysia Airlines has to bear the costs. The "Everyday Low Fares" strategy helps Malaysia Airlines via fuel surcharge to provide contribution to its fixed cost. This can be shown by the 6 per cent increase in revenue to RM3.7 billion from RM3.5 billion; its profit falls from RM132.7 million to RM120 million as the increase in fuel prices is more than its surcharges in the first quarter of 2008 and 2007 (New Straits Times, 21 May 2008).

As fuel prices kept on rising, Malaysia Airlines had increased its fuel surcharges five times in 2007 and had also increased them on international routes with exception of China routes by 25 per cent to 80 percent in June 2008 (New Straits Times, 28 June 2008). The increase in Malaysia Airlines fuel surcharges was as follows:

| Route range to / from Malaysia | % increase range |
|---------------------------------------|-------------------------|
| Short haul / Asean sectors | 25% - 67% |
| Medium haul sectors | 28% - 50% |
| Long haul sectors | 30% - 80% |
| Ultra long haul sectors | 35% - 63% |

Source: New Straits Times (28 June 2008), Higher fuel surcharge, Biz News, p 31.

The airline also intends to reduce its capacity by 6% on less profitable routes during the low season. The IC of the “Everyday Low Cost” seat is between RM25 to RM35, and its average fare is RM90 per seat. Thus the claim of cross subsidy is without any basis as the revenue from “Everyday Low Fares” strategy exceeds its IC.

Another issue is the claim of predatory pricing. Faced with escalating fuel prices, the airline has to devise strategies that its seats can be sold so that the escalating cost of fuel can be fully or partially recovered. What Malaysia Airlines does is to substantially reduce the fare for the unsold seats. Although the incremental revenue is not significant, the airline can recover some of the overall cost through its fuel surcharge. Such a strategy can reduce the 30 per cent unsold seats, and thus reduces its cost.

In order to consider whether an aggressive pricing is predatory, it must be proved that Malaysia Airlines has the intention of driving AirAsia out from the industry and to obtain market dominance (see McGee, 1958 and Gundlach, 1995), prices its product below variable cost and recoups the losses once AirAsia exits the market. On intent, there is no evidence that Malaysia Airlines has the intention of driving AirAsia out of the market, as all players in the airline industry are experiencing a tough time in dealing with soaring fuel prices and the competition. On recoupment, there is unlikely that Malaysia Airlines can recoup the “losses”, as the industry is very competitive. In the United States as in the case of *Matsushita Electric Industrial Co. v. Zenith Radio Corp.* (1986), the Court stated that:

The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator’s losses and to harvest some additional gain. Absent some assurance that the hoped-for monopoly will materialize, and that it can be sustained for a significant period of time, ‘the predator must make a substantial investment with no assurance that it will pay off.’ For this reason, there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful (as reported by by American Bar Association, AntiTrust Section 1992a, p. 236).

Thus, Malaysia Airlines’ aggressive pricing is not predatory, as its action is to generate more revenues to cover some of the costs due to the increase in the fuel prices which has doubled from 15 - 20 per cent to 30 – 40 per cent of its total operating costs.

What motivates AirAsia to claim that Malaysia Airlines practices cross subsidy and predatory pricing? One of the reasons is that price war has reduced AirAsia profitability and cashflows. As fuel prices keep on soaring and Malaysia Airlines attempts to sell unsold seats at low fares, AirAsia’s cashflows and profitability will be greatly affected (New Straits Times, 16 May 2008b). With 60 per cent to 70 per cent of AirAsia’s profit came from the local market, the Malaysia Airlines’ zero fare campaign could affect AirAsia’s forward bookings and yields. In addition AirAsia was committed to A320

delivery schedule, and the ballooning of interest costs and depreciation would push down profit margin even lower.

Another reason is that AirAsia's cost of funding will depend on its market share price performance. If its share price is weak, AirAsia's ability to attract investors will be weakened, and existing investors will reduce their holdings. This can be seen by the action of institutional shareholder T. Rowe Price Associates Inc. which has steadily reduced its holding by selling 3.7 million shares in the month of June (New Straits Times, 24 June 2008).

Why do we have competition? The aim of competition is to direct resources to the uses that will give the best benefits to consumers in the short run as well as in the long run. In the case of the current price competition between Malaysia Airlines and AirAsia, the consumers are benefiting because they pay low fares. Every body can fly now without really burning their pockets. In conclusion, the price competition between Malaysia Airlines and AirAsia has benefited the consumers.

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