Political Economy of Competition Policy in Japan:

Case of Airline Services

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1. Introduction

The Airline services industry in Japan has gone through gradual, but cumulatively tremendous changes in the last fifteen years. Before 1986, routes were controlled by regulation: international routes were served by Japan Airlines (JAL) only; domestic major routes were served by JAL and All Nippon Airlines (ANA); and domestic local routes were served by ANA and Japan Air System (JAS). Airfares were also tightly regulated: airfares were approximately proportional to the distance of the route; no discount airfares but round-trip discounts and multiple-coupon discounts. New entries to passenger service were not allowed or not even attempted.[1]

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[1] See Ito, Takatoshi (1992). *Shohisha Jushi no Keizaigaku* (trans. "Consumer-oriented Economics"), Tokyo: Nihon Keizai Shinbun sha, for comparing the deregulated US and regulated Japan in the 1980s in the pricing and other characteristics of the airline industry. See also Ito, Takatoshi and Hirotaka Yamauchi, (1996). "Air Transport Policy in Japan," in G. Huffbauer and C. Findlay (eds) <u>Flying High,</u> Washington, D.C.: Institute for International

However, in 2003, airfares are as diverse as those in the US market. Although regular fares are still proportional to distance, availability of discount airfares depends on the season, day of the week, time of the day, advance ticketing, birthday of a passenger, and, most importantly, competitive pressure of the route. The deep discount (restricted days with far-advance ticketing) could be more than 60% off. New entries to the industry took place in the last five years. JAL and ANA compete against each other in many of the routes, both international and domestic.

Although deregulation produced massive gains among consumers, the future of the industry may not be as promising as before. Newly entered companies, Air Do, Skymark Airlines, and Skynet Asia, are not thriving. Air Do has failed once, restructured, and now has affiliation with ANA, while Skymark and Skynet are surviving. The number one JAL and the number three JAS merged and integrated their network last year, so that there are only two major airlines in Japan now.

Even in major countries in the world, airline failure and mergers are in progress. Many companies failed and taken over by others or rehabilitated with protection from creditors: Swiss Airlines, United Airlines, Air Canada, Air New Zealand. Some of the reasons for the difficulty among major airlines in the world may be common—such as SARS and 9-11—but many of them are idiosyncratic. As airline services became global, and several hub-and-spoke systems have become successful, and some others

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Economics, 1996: 33 – 61, for some of the major deregulation steps in the late 1980s and the early 1990s.

failed. The mergers and failures have barely come to Japan and its neighboring countries in Asia. The decision to allow a merger of JAL and JAS is a first of major mergers in the region.

The appearance of competitive pressure in the airline industries in Japan has become deteriorated in the last few years. First, the so-called shuttle service, a fix-price inter-carrier common ticket system, for the three carriers (JAL, ANA, JAS) was permitted by the Fair Trade Commission of Japan (FTCJ) and introduced between Tokyo and Osaka (either Itami or Kansai airports). This is an apparent collusion. Second, the merger of JAL and JAS and the affiliation of ANA and Air Do have lessened the number of operating companies from 4 to 2 in the route of Tokyo-Sapporo, the busiest route in the world. Third, a normal domestic fare was raised with permission of the Ministry of Land, Infrastructure and Transport (hereafter the Ministry), despite deflation in many of other prices.

To anticipate conclusions, the appearance of declining competition can be rebutted as follows. First, allowing the shuttle service is based on the view that there is enough competitive pressure from the high-speed rail between Tokyo and Osaka so that an apparent collusion would not make airlines gain monopolistic power. Second, a merger of JAL and JAS may be justified from pursuing efficiency (scale economies) in a more competitive environment. However, monitoring the industry development for maintaining competitive pressure is important, and assuring the access to facility by new entrants to the market is important.

It is a challenge for the regulatory agencies what kind of competition policy should guide the regulatory policies of the airline services in Japan. In addition, there is a possible conflict between the Ministry and FTCJ over regulatory issues of pricing and routing.

The rest of this paper will be organized as follows. Section 2 describes some of the recent cases involving competition policy in the Japanese airline industry and section 3 points out challenges in the competition policy in the future.

2. Cases

2.1. Shuttle Service

In 2000, JAL, ANA, and JAS applied for introducing a concept of "shuttle" service in the Tokyo-Osaka (Itami or Kansai airports) route. The shuttle service is to standardize the airfare and make the ticket common usable interchangeably among the three companies, and expedite the boarding process. Joining the forces, the airline offer frequency of two or more flights every hour. (Schedules could not be coordinated so that "on-the-hour, on-the-half-hour" service was not introduced in the beginning. After a few years in operation, it is now converging to a situation that JAL offers half-hour service, while ANA offers on the hour service.) On the surface, this is a blatant collusion.

In the case of the original shuttle service in the U.S., between Boston and New York, and between New York and Washington, measures have been taken to ensure that two airlines would be competing in the same route.[2] Another example is the shuttle between Singapore and Kuala Lumpur where Singapore Airlines and Malaysian Airlines have the check-in counter side-by-side and accept the ticket of each other.

The shuttle service between Tokyo and Osaka was proposed with a notion that airlines, collectively, would be competing against the bullet-train (*shinkansen*), that introduced a faster train service between Osaka and Tokyo. It takes only two and half hours for the fastest train between the Tokyo station and Osaka station. It takes just one hour for an airline between a gate at the Haneda airport and a gate at the Itami (Osaka) airport. But, when travel time from downtown Tokyo of Osaka to the airport, and waiting time at the airport is counted, airlines barely have an advantage in total travel time. In order to compete against the *shinkansen*, waiting time at the airport was targeted to be cut down.

According to the logic of airlines, the Tokyo-Osaka is under strong competition from *shinkansen*, so that an apparent collusion among the airlines does not make it possible for airlines to exercise monopoly power. In other words, the price elasticity of demand for airline services is quite high, and the monopoly pricing would not be much different from marginal costs.

[2] Originally, the route was exclusively served by Eastern Airline before the deregulation of the 1980s. Passengers could just walk in a plane up to a few seconds before closing the gate without reservation or check in. The payment was made on board. It was quite efficient in terms of waiting time at the airport. In fact, no reservation was taken. If a plane became full, a second plane would take off in fifteen minutes. After deregulation, New York Air entered the market, and Eastern and NY Air were competing in the shuttle market. When both NY Air and Eastern was taken over by Continental in 1987, it was ordered to spin out the shuttle service to PanAm. When PanAm failed, the shuttle was sold to Delta, and when Continental developed the financial difficulty, its shuttle was sold to US Air.

The airlines logic won, and the FTCJ allowed the shuttle service. Indeed, pressure from trains is real and consumers are offered of real competitive choices.

The validity of the airlines logic and FTCJ's affirmative decision rests on several assumptions. First, it is assumed that train fares are determined independent of airfares. In other words, there would not be implicit collusion between airlines and train companies. Second, when there would be significant (downward) changes in cost structure of airlines, the shuttle prices would be adjusted. Third, the explicit price fixing that would involve communication among the airline companies in the Tokyo-Osaka segment would not lead to tacit collusion in other markets.

On the first point, it was thought that train fares of *sinkansen* would not be affected by developments in the airline industry at all. If any, fares of the fastest trains were decreasing. However, in October 2003, shinkansen train fares were essentially raised by making expensive fastest train services more frequent. One may wonder whether the *shinkansen* fare raise was possible if airlines were competing. An assumption may not be completely obvious. Second, change in shuttle airfares has not occurred yet. The assumption is not put to the test. Third, tacit collusion because of friendly relationship in the particular segment is a worry, and this should be monitored carefully in the future.

2.2. Merger of JAL and JAS and Affiliation of ANA and Air Do

In the Japanese airline industry, three companies, JAL, ANA, and JAS, have been major companies. In the international markets, JAL has been dominant, and ANA is new to the market (it was allowed to enter international routes late 1980s). JAS had only a few, short-distance destinations. In the domestic market, ANA has been the largest company. JAL was competing with ANA in major routes, but many routes were served by ANA only. JAS was a distant third.

In 2002, JAL and JAS announced a plan to merge. This would not change a picture in the international markets, but create a network of domestic services that would rival ANA. The competitive situation in domestic market significantly change.

In March 15, 2002, the FTCJ publicly published a concern over the planned merger of JAL and JAS.[3] In the published concern, the FTCJ raised several points.

(1) The number of major companies will decline from 3 to 2. This makes it easier for them to practice collusive pricing behavior.
(2) The ratio of special discount fights is less and the discount percentage of special discount flights is lower in the routes where the number of competing flights is smaller. Therefore, the reduction in the number of competing companies may reduce competitive pressure.
(3) Due to congested airports and restrictions on landing rights and check-in counter space, new entries are extremely difficult. Therefore, pressure from new entries cannot be counted on.
(4) As a result, consumers will suffer.

The data analysis to back up these concerns, especially point (2) above, is compelling.

[3] www.jftc.go.jp/pressrelease/02.march/020315.pdf

The relationship between competitive pressure (reverse of the number of competing airlines) and pricing is shown convincingly. In other words, contestability from potential entries is not necessarily working. The ratio of all of the flights in the routes being offering special discount fares is 48.3% for the routes with monopoly; 56.8% for the routes with duopoly; and 73.1% in routes with three companies competing. The average ratio of special discounts was 15% for monopoly routes, 18.9% for duopoly routes, and 26.0% in three-company routes; and 38.7% in four-company routes. This is quite an interesting result.

The restrictions on new entries, point (3), are serious from those who hope that contestability would be an answer to the problem of oligopoly that is inevitable for network industries such as the airline industry. Reading these points, the approval of the merger may not be easy to come.

However, JAL and JAS offered a counter proposal on April 26 with the following counter-measures, and those measures were regarded satisfactory by FTCJ.

(1) Normal airfares will be reduced by 10%. The airfare would not be raised in at least three years unless business environment changes drastically.
(2) Special discounts will be offered in all routes that are competing with another major airline, or new monopoly routes due to the merger of JAL and JAS. The degree of discounts would not change.
(3) The JAL-JAS will make efforts to enter ANA-only routes or increase the number of flights in routes dominated by ANA.
(4) 9 slots (landing rights) at the Haneda airport will be given up. Moreover,

if new entrants are planned, additional 3 slots will be given up. The latter measure is until 2005 when overall slots will be reviewed.

(5) When new entrants are planned, JAL-JAS will make efforts to accommodate in airport facilities and maintenance of airplanes.

Of these measures, (1)-(3) corresponds to the FTCJ concern on competitive pressure due to the number of competing companies. Even if the number of companies declines from 3 to 2, the market results (pricing) would not deteriorate, but improve (lower airfares). Counter measures (4)-(5) are an answer to the concern on physical restrictions on entry. The JAL-JAS will cooperate in efforts to encourage entry.

At this point, the promise of lowering airfares sounded significant in rebutting a criticism that a merger would lead to higher prices. But, it was not known that airfare would be hiked only a year later. This will be explained in the next section.

It can be argued that reverting back 9 slots (possible 3 more) is good enough to encourage new entries. In the case of US mergers, it was frequent that some routes were required to be spun off. If contestability is taken seriously, then a general policy on allocating landing slots should be developed.

In the end, the merger was approved on the condition of counter measures. As a result of a merger by JAL and JAS, and code sharing (affiliation) of Air Do with ANA effectively reduced the number of competing airlines form 4 to 2. After the consolidation, JAL offered 21 round trips, and ANA (with ADO) offered 24 round trips a day as of April

2003. With these dense schedules by the two giants, it would be very difficult for any potential entrant to break in this market. Since 1972, the Tokyo-Sapporo routes were served by three or more companies. The duopoly situation with deregulated environment is quite new, and it should be monitored carefully.

2.3. Increases in Normal Airfares

The Ministry announced in January 2003 that it would raise the landing charges of airports starting April 2003. In response, JAL and ANA announced a plan to increase airfare that would shift the incidence of landing fees to passengers, effective in April. However, Minister Ougi announced that she would oppose the airfare increase based on an increase in landing fees, stating that the cost increase should be absorbed by efforts in management. (Reported in Nihon Keizai Shinbun, January 20, 2003.) In response, JAL and ANA announced that they defer the date of airfare increase by two months. Basically, the Ministry denied JAL and ANA from raising airfares due to cost increases. Then, in late March, JAL and ANA switched a strategy. They argued that the business environment had changed due to the higher jet fuel prices due to the Iraqi war, and fare increases were planned for June 2003. However, this argument was rejected by the FTCJ. The FTCJ argued that it would be premature to judge that the business environment had changed due to the Iraqi war. Recall that JAL had promised that it would not increase the airfare unless the business environment changes drastically. In the end, the March plan for fare increases was scrapped.

Finally, in April, JAL and ANA applied for fare increases on the basis of deterioration of the business environment due to SARS. (See JAL press release on April 28, and ANA press release on April 30.[4]) This was approved.

In the end, the airline companies got airfare increases (or re-winding of the airfare decreases, a condition for the JAL-JAS merger).

This episode poses three questions. First, would a similar amount of pressure for airfare increases have been possible had the JAL and JAS merger not taken place a year earlier? Second, was the reason (justification) for the airfare increase correct? Third, who and on what basis the airfare increase be regulated?

First, one critical view is that, now that there are only two major airlines, an implicit collusion can be easier for them and the episode shows that it is a real threat. An opposing view is that what was raised is normal airfare, and most of the competition occurs at the discount airfare, so the availability and degree of discounts depends on competitive pressure, which comes from contestability (threat of new entry). An important part of regulation is to assure new entries. Second, the exchanges of the plan and rejection/approval between airline companies and the regulatory agencies (the Ministry and FTCJ) in the spring of 2003 shows inconsistencies in regulatory reasoning. If airlines plan to raise airfares for the justifiable reasons of cost increases that are rising for external reasons, such as landing fees and jet fuel price increases, then the plan should be permitted. On the other hand, if airlines apply for airfare increases on the ground that demands are lower, such as effects of SARS, then the application should be rejected. A shift of cost (supply curve) upward should raise the price, while a shift in

[4] JAL press release (in Japanese) at www.jal.co.jp/press/2003/042801/042801.html and ANA press release (in Japanese) at svc.ana.co.jp/pr/03-0406/03-052.html.

demand curve (to left) should lower the price, in the competitive market. For this reason, the rejection of the first fare increase by the Ministry and FTCJ was wrong, and the acceptance of the second fare increase by the Ministry and FTCJ was also wrong. But, at the end, the airlines got fare increases that could be justified by the first reasoning. Would two wrong answers make one right?

Third, it should be clarified whether what kind of fare increases are subject to approval of the Ministry, and what kind by the FTCJ. It should be clear that the FTCJ should supervise the overall competitive environment, and any airfare matters related to competition should fall on the FTCJ's supervision.

2.4. Entries of New Airlines

As the deregulation proceeded, Air Do entered the market of Tokyo-Sapporo route in 1998. The market was already crowded with three major airlines and frequent services. Air Do offer discount airfares but only two round trip flights. JAL, ANA and JAS countered the challenge of the new entry by lowering their airfares of the flights that are close in departure time to Air Do flights. This was close to predatory pricing. The FTCJ then did not act. Although Air Do did well in the first several months, their load factor deteriorated after 1999. Air Do never made profits and failed in 2002. Old stock holders including the Hokkaido government took losses, and new Air Do is operating in affiliation with ANA. (ANA buys a certain potion of seats on Air Do flights, and put a code share flight number. Pricing of seats are done independently.)

Another new entry was made by the Skymark Airlines in 1998, for the Tokyo-Fukuoka route. The third new entry was planned in 2002 by Skynet Asia Airways (SNA) for the routes between Tokyo-Miyazaki. For the Tokyo-Miyazaki route, SNA set the normal airfare 21,000 yen, and two-coupon discount at 18,500 yen, when the majors had set normal airfares at 31,000 yen, and a discount airfare at 23,500 yen.

However, JAL, JAS, and ANA lowered airfares for the routes of Tokyo-Miyazaki, Tokyo-Fukuoka, and Tokyo-Kagoshima. For Miyazaki, the majors planned to lower normal airfare to 27,900 yen, and special discount at 22,000, and further reduction in November at 18,500 yen (matching the SNA flights). Moreover, the majors planned special bonus miles for their frequent flier (mileage) programs. Similar airfare reduction was planned for Tokyo-Fukuoka, and Tokyo-Kagoshima.

In response, the FTCJ warned the majors about the possibility that the pricing may violate prohibition of monopoly (Anti-Trust Law, article 3). The warning was issued on September 26, 2002.

The warning had an immediate impact. The three majors decided to increase special discount airfares from December.

The logic of the FTCJ warning, as explained in the FTCJ documents dated September 30, is as follows: A deeper discount by the majors was targeted only in the three routes that compete with new entries. Discount percentages are much higher for these three routes, as documented by the FTCJ. Moreover, bonus mileages are applicable only for the Tokyo-Miyazaki segment. These actions were regarded as unfair trading practices, similar to predatory pricing, on new entries.

I summarize two views on this episode.

One view is that the FTCJ's action is over-regulation that harm consumers' welfare, because special discount airfares (by the majors) were raised as a result of FTCJ warning. Applying a break on lowering prices is misguided. Competition policy should promote competition, not restricting competition (that is, lowering prices by existing firms). New entries should not be treated any differently from existing companies. A typical predatory pricing would have a scenario in that low prices by a major company (incumbent) would drive out a minor company (new entry), and then prices would be raised after the exit of the minor company.

Another view based on the importance of contestability would support FTCJ's decision. For successful implementation of competition policy, it is important to make sure that pressure from potential new entry is applicable. In order to maintain pressure from potential entry, it is important that actual new entries would not be subject to unfair competition. The airline industry is inherently oligopolistic (since scale economies and network values are important), and it takes time for a new entry to develop a network. Targeting a new entry by reducing special discount airfare is indeed unfair, and would reduce the degree of contestability in the future. Maintaining contestability, sacrificing short-term lower prices, will lead to lower prices in the long run. However, this kind of restrictions on pricing behavior of existing airline companies should be temporary (say, two years). A similar restriction on existing airline company was established in Germany (Lufthansa vs. a new entry).

In summary, the tradeoff is whether to offer low prices now for consumers or to preserve contestability for the future. My view is that the decision to put weight on the latter is prudent in the industry with large oligopoly firms. In this sense, the FTCJ has evolved in a desired direction from no action in 1998 to active involvement in 2002.

3. Challenges for the Future

The four episodes in the preceding section poses difficult choices in competition policy regarding the airline industry in Japan. Keeping competitive pressure, while allowing companies to pursue scale economies (network externality) is a challenge. Different views, and my personal view, on actions by the Ministry and the FTCJ on each of the four cases are presented. Now that there are only two major airlines, it is most important to maintain competitive pressure through potential entry. Giving a new entrant a preferential access to the common facility, such as facilities in the terminal building and landing slots, with some limited time (say, several years), may encourage the entries, and maintain competition. In this respect, a recent report on the direction of Japanese competition policy is on the right track.

In order to maintain competitive market practices, the FTCJ should play a greater role monitoring pricing behavior and other business promotions and practices. Giving freedom to airline companies in developing new services and products is important, but that should not unfairly drive out competitors from the market. Whether the normal fares, essentially the ceiling of variety of airfares, can be increased can be judged in relation to competition policy, so that it falls on the role of the FTCJ. The Ministry's role is more basic, such as the safety, the international treaties, and the air traffic control system..

In the future, Japan will be more integrated in the Asian region. When the free trade agreements develop more in Asia, after the one between Japan and Singapore, regional competition may spill over into domestic markets, just like in the EU. Taking a model of EU, subsidiaries of a foreign carrier may be allowed to serve domestic routes. Japan may be better off taking a leadership role in negotiating mutually freer skies in Asia. That would be an ultimate solution for maintaining contestability in the airline industries.