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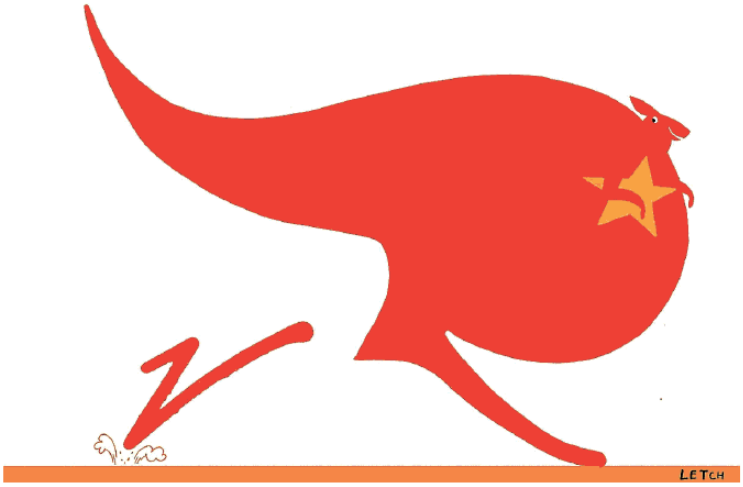
Bail out Virgin, or we will suffer

If Qantas becomes our sole carrier, expect fare rises as there will be no pressure to mitigate profit in consumers' interests.



John Asker and Richard Holden

Virgin Australia is on the edge of collapse. The board met Monday night and the airline entered voluntary administration yesterday. That pushes more than 10,000 employees closer to permanent job losses. Customers who have bookings may not get a refund.

But it also pushes the Australian airline industry closer to monopoly once the COVID-19 crisis has passed. And it is all these prospects that weigh heavily in favour of government support for the airline. So far, the federal government has resisted doing so. But it should reconsider after confronting the facts of the case.

In the last 12 months, more than 60 million trips were taken on domestic air routes. For a country of 25 million people, that is a startling number. That is roughly two and a half domestic plane trips per Australian, per year.

Of course, many of these trips are taken by tourists, but even factoring in the 9 million or so tourists that visit each year, it is clear air travel is a crucial part of the tapestry that knits Australians together.

Due to the COVID-19 pandemic, one of our two principal air carriers, Virgin, is on the brink of collapse. It needs a $1.4 billion cash infusion to get it out of administration. Although there is some possibility of a private-sector buyer, the federal government is the natural provider of those funds – ensuring meaningful continuity of operations. To put that in perspective, it amounts to the federal government spending $23 on every air ticket sold in Australia, for a year.

Of course, loans get paid back. Or at least they should. So that $23 figure dramatically overstates the real burden of such a bailout on the taxpayer. But let's just work with that $23 number and consider what that would buy Australia.

A central problem with not supporting Virgin is the loss of competition post-crisis that would result from the exit of a significant market player. Qantas (including Jetstar) has a market share, measured in terms of capacity, of about 57 per cent, whereas Virgin (including its Tigerair subsidiary) has a market share of roughly 38 per cent. In other words, domestic air travel is a two-firm game. Virgin's exit would leave one big established player with no competitive pressure to mitigate the incentive to generate returns for shareholders at the expense of consumers.

There are, of course, some budget and regional carriers but the key market here is what Australian Competition and Consumer Commission chair Rod Sims calls "full-service airlines".

Put bluntly, basic economic analysis, of the sort routinely deployed in competition matters, indicates that if Virgin exits consumers will suffer.

It's not hard to see that consumers would likely suffer by more than $23 per trip if Virgin were to exit. The average cost of the cheapest fare on an Australian plane is about $170. So if you think that, if Virgin exits, airfares will go up by more than 14 per cent of the price of the cheapest seat in the plane, then that bailout for Virgin already looks pretty good.

Would prices jump by that much? That data suggests a price jump of that magnitude would be unremarkable. In the past 12 months, the price of the cheapest seat on a plane has jumped by 37 per cent. Given this, a monopolistic Qantas may be able to sneak in an extra 14 per cent boost to the bottom line. While, ultimately, consumers' price sensitively would determine whether that would be possible, we worry consumers may not even notice a price surge of this size in the face of the probable ongoing turmoil at this stage of the pandemic.

> *This is not a simple governance failure of Virgin – it's a Black Swan event.*

Every economist that works on competition issues would agree a reduction in the number of firms, moving from competition to monopoly, will hurt consumers. This is not controversial theory, but rather a pattern that has been observed repeatedly in industry after industry, data set after data set, and research study after research study, over many decades.

Competition aside, it is worth remembering that the exit of a large firm such as Virgin also has real impacts on its employees, suppliers and business partners. People are not flying because of circumstances out of Virgin's control. This is not a simple governance failure at Australia's second carrier – it's a Black Swan event.

On this basis, the case for supporting Virgin seems clear. Ensuring Virgin remains a healthy competitor is a worthy investment that would likely benefit Australian consumers.

All that said, the appropriate policy response requires careful thought. Bailouts should be rare and structured to provide real value to taxpayers. Consumers must benefit, and that loan better get repaid, even if Virgin shareholders take a hit. This could be ensured by making the loan convertible into equity if not repaid on time.

Virgin is in deep trouble. Getting support will protect Australian consumers at a low cost, relative to the cost of a loss in competition if Virgin fails. Protecting the interests of consumers as we move through this unique time in our economic history should be a core focus of industrial and economic policy.

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A taxpayer rescue was always a flight of fancy

Neil Hansford

Virgin Australia's entry into administration is the inevitable consequence of unserviceable debt, poor strategic decisions and cost reductions that started far too late for the company to have any chance of weathering the storm.

No reasonable person could believe the federal government should commit $1.4 billion of taxpayer money to such a business.

The fundamental Virgin business model was unsound. With a debt to be serviced believed to be in the order of $5 billion, the company was not in a position to pursue its international adventures.

Virgin continued to challenge Qantas on Australian mainline routes and expected the fruits from this stable business to cover its international expansion. But this required heavy front-end expenditure it simply didn't have.

One has to wonder about the decision process that saw Virgin move away from the successful operation that was Virgin Blue and what oversight the board applied to this decision. The Virgin Blue low-cost carrier caused Qantas to launch Jetstar to maintain market share. Clearly Australians were voting with their credit cards to travel on a "no-frills" airline.

Why, when there were still many domestic routes that could have been launched, was the company allowed to change its operation to take on Qantas in the higher-yielding government and commercial market? This required high investment in business class, lounges and the other costs of premium travel. It changed its web-booking engine, New Skies, to a higher-cost distribution tool. Jetstar is still using the New Skies booking engine for its reservations.

The egos on the board were starry-eyed and believed they could compete with Qantas and its Frequent Flyer Program. Clearly consumer choice of carrier is heavily influenced by frequent flyer miles and status, and Qantas's program is one of the best. Virgin management underestimated it to its peril.

In recent years, the company has accrued losses of over $1 billion on a turnover of $23 billion. There is no better sign that its strategy wasn't working, not to mention that Virgin was not paying a cent of tax.

The Virgin shareholding has always been a difficult mix, with more than 90 per cent foreign ownership at the time of the airline's collapse. It is significant that Air New Zealand reluctantly sold its substantial shareholding when it could no longer influence the company's direction from one it was unhappy with.

The shareholders had very different agendas. Government-owned Singapore Airlines wanted Virgin to feed to its international network. Etihad, also state-owned, in this case by Abu Dhabi, had similar aspirations to Singapore Airlines. The Chinese shareholder, Hainan, an instrument of the Chinese Communist Party, saw Virgin Australia as a method to get services to Hong Kong to support Hong Kong Airlines and Hong Kong Express. Nanshan, one of China's top 500 companies, saw its VA investment as part of its international expansion. Richard Branson was most keen to protect the royalty for the Virgin name, which Virgin Australia paid him from Day One.

When the government rebuffed its call for a $1.4 million loan, management asked its well-heeled shareholders to come forward with a billion dollars in funds. They all declined to commit in realistic terms to refinance or sell to each other.

There were suggestions that unionised superannuation funds should step up, but as one former union leader said the investment was too risky for a super fund. If none of these groups would stump up, why should taxpayers?

The narrative pushing a bailout has been driven by the Qantas and Alan Joyce haters and those who are concerned about a possible Qantas monopoly.

The ACCC's Rodd Sims would be watching Qantas should that ever eventuate and would keep it honest. And, as the Treasurer has said, there is plenty of interest from new buyers.

Regrettably, Virgin has become a political football, kicked about by those with no real interest in 10,000 great Australians who put their heart and soul into building the company. But with such a poor business strategy, administration was already likely and inevitable once COVID-19 hit the world.

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