4 Airline Business and Marketing Strategies

We have now completed our coverage of the essential building blocks in the application of marketing principles in the airline industry. No airline can hope to apply these principles successfully without the understanding of customer needs and the marketing environment which Chapters Two and Three have provided. Once such understanding is in place, the next requirement is the challenging one of the formulation of a sound strategy.

In one sense, the news here is good in that in today’s airline industry there is no single, unique strategy which must be followed if success is to be achieved. There is a range of possible strategies available. What is essential, though, is that one strategy must be selected from this range. It must then be implemented well, and continued on a long-term basis. The aim of this Chapter is to set out and discuss the types of possible strategy, and their advantages and disadvantages.

4:1 Porter’s “Five Forces” and their Application to the Airline Industry

In understanding these strategic options, a useful start can be made by looking at some of the ideas of the Harvard Professor, Michael Porter.¹¹ Porter states that in different industries, strategic issues are coloured by the interplay of the Five Forces of the rivalry amongst existing firms, substitution, new entry, the power of customers and the power of suppliers. We will examine each of these in turn.

4:1:1 Rivalry amongst Existing Firms

Porter argues that, in many industries, often little of the true competition and the drive for change comes from long-established firms. These long established firms often resemble one another in terms of the strengths which they have, and in their problems and weaknesses. They therefore

can only identify benefit from aggressive competition at the margins of their activities.

In the air transport industry, the policies of the long-established airlines of Europe illustrate this point only too well, especially in their short-haul markets. As we saw in the last Chapter, there are now no regulatory reasons which preclude intense competition between them. Since April 1997, the airlines of the European Union have competed in a Single Aviation Market where there have been only the very loosest controls over entry, capacity and fares. This represented a major change when it took place compared with the tight regulation characteristic of the previous system. Yet, one would hardly know that this change had occurred if one had merely looked at the reaction of the old-established airlines to it. They continued to fly mostly similar aircraft (usually drawn from the Airbus A320 family), and placed in them identical or near-identical seating configurations. Frequencies and timings remained very similar, with few airlines prepared to allow their competitors a frequency advantage. The on-board products were mostly comparable, and did not change. Finally and most tellingly, until recently these airlines pursued an almost identical pricing policy. Very high fares were charged for seats in Business Class, and for access to Economy tickets which allowed full flexibility. Lower fares were also on offer, but these had had tight restrictions attached to them, restrictions which were mainly designed to prevent business travellers using them.

The result of such policies was that they made it much easier than it should have been for new Low Cost Carriers to grow in Europe, and for them to have a dramatic effect on the economics of the long-established firms. British Airways, for example, lost nearly £250 million on its intra-European network during its 2002/2003 financial year.

4:1:2 Substitution

Porter argues that disturbance to the competitive equilibrium set up by the long-established firms can come from two possible sources, the first of these being that of Substitution. Substitution occurs when firms in another industry find a new and better way of meeting the same customer needs as are being targeted by the existing players.

There are a number of Substitution issues affecting airlines at the present time. Of these, potentially the most serious is the effect of electronic methods of communication on the market for business air travel. As we discussed in Section 3:5:1, videoconferencing, teleconferencing and email all have the potential to mean that business travellers will travel less, and still satisfy their needs for effective communication. At the time of
writing, there are worrying signs that this is exactly what is happening, an effect which is likely to increase still further during future downturns similar to the one which followed the September 11 attacks in 2001.

Surface transport, especially by rail, also raises important substitution issues. As we have seen, unlike airlines, railways can provide city-centre to city-centre travel, and have been shown to severely impact the business travel market once these city-centre to city-centre journey times can be brought down below three hours.

The air freight industry is also being affected by Substitution issues. Email is substantially reducing the market for the movement of urgent documents by air. Also, newspapers do not provide the lucrative air freight commodity they once did. They still lose their value completely soon after they have been published. The problem is, though, that today media publishers are increasingly reaching their readers through the Internet, or by setting up satellite printing stations which enable newspapers to be printed simultaneously in a large number of different markets. They therefore no longer have to make use of air freight.

4:1:3 New Entry

The second of the forces which may disturb the competitive equilibrium amongst the existing players is that of new entry.

In some industries, new entry is difficult or impossible. In others, it is commonplace. In the modern aviation industry, the latter is very much the case, especially in short-haul, point-to-point markets. This is because of the many possible so-called “Barriers to Entry”, most have become low or are now non-existent.

A first possible barrier to entry may result from regulatory limitations. It is true that, as we saw in Section 3:2, there are still regulatory barriers to entry in many international markets, and airlines are constrained in their market entry policies by out-of-date and anachronistic limitations on ownership and control. However, it is now the case that many of the world’s largest domestic markets, such as those of the United States and the European Union, now operate without any significant entry controls, apart from those applying to so-called Cabotage Rights.\(^1\)

In others cases, resources may act as a Barrier-to-Entry. If vital resources are unavailable or very costly, entry will clearly be constrained.

In the aviation industry, airport slots provide a classic resource barrier to entry. As long as airport slots continue to be awarded under the Grandfather Rights principle which we discussed in Section 3:2:6, it will be

---

\(^1\) See the “Glossary of Aviation Terms” at the end of the book.
very difficult for new entrants to gain access to attractively-timed slots at congested hub airports.

Significant though slot constraints already are, with a likely worsening of them in the future, radical strategies are possible which find a way round them. In particular, Europe’s vibrant low-fares scene - the subject of Section 4:2:2 and 4:2:3 - has largely grown free of airport slot constraints because of the willingness of the airlines to use uncongested airports, sometimes located a considerable distance from the cities they are designed to serve.

Slot constraints may provide some comfort to existing airlines in Europe today, but they can derive little more from the remaining possible resource constraints to entry. Especially during downturns such as the one experienced during 2002 and 2003, resources to underpin entry can actually be remarkably cheap and plentiful.

This is certainly the case with the question of the aircraft fleet that will be needed by a new entrant airline. In a recessionary period, aircraft manufacturers will be prepared to strike very attractive deals for the white-tailed aircraft which sometimes result from order cancellations. Also, there will be large numbers of parked aircraft – many of them owned by leasing companies – where the owners will offer extremely low lease rates in order to get their idle aircraft flying once again.

Staff resources – especially of pilots and mechanics – will also be important. Again, in a recessionary period many trained people will unfortunately lose their jobs, and may well be prepared to take new ones at relatively low salaries and wages in order to obtain employment.

As a final, and, at first sight, odd feature of resource constraints on entry in the aviation industry, it will always be possible for a new entrant to buy the support services, such as maintenance and ground handling that it needs. Many airlines have built subsidiary businesses offering such services and they will be prepared to sell these to a new entrant, even if the new entrant’s business plan involves competing with them. They will reason that if they do not meet the need, this will not stop the new entrant. Instead, the required services will be bought elsewhere, denying the first airline some useful revenue.

Several more issues need to be covered in assessing the nature of barriers to entry in the airline business. Some industries are characterised by marked *Economies of Scale*, where lower unit costs can be obtained by large-scale producers. Many heavy industries such as steel, chemicals and car-making are like this. In them, existing firms are likely to be protected against entry because they will have been able to achieve a scale of production which is unlikely to be available to a new entrant.
In the airline business, there are some aspects where existing players are protected against new entry by scale economies. In particular, hubbing operations where short-haul passengers are collected together in order to feed long-haul services are increased in their effectiveness by being undertaken at a substantial scale. It is hard for small new entrants to break in. In point-to-point markets, however, no such protection for incumbents exists. Economies of Scale in areas like pilot training and maintenance quickly run out with increasing size, and are counterbalanced by the bureaucracy and poor staff morale often characteristic of large airlines.

In some industries, incumbents have a lot of protection against new entrants because of so-called Learning Curve effects. In them, mature firms achieve lower costs than new entrants because the intricacies of the production process mean that substantial experience is required before optimum cost levels can be achieved. Aircraft manufacturing and aero-engine production both illustrate this from within the aviation industry, with unit costs of production falling steadily as an airframe or engine family matures. Airlines, on the other hand, seem to show the opposite effect, with the concept of Start-up Economics a well-established one. Airlines often achieve their lowest costs of operation during the first five years of their existence. Later, costs tend to rise as more staff ascend seniority scales to higher rates of pay, and bureaucracy and declining staff morale start to impact on cost levels. The existence or start-up cost advantages does of course, make the task facing a new airline a significantly easier one.

One final issue with regard to entry into the airline industry is difficult to analyse, but very important. Over the last twenty years, the list of airlines which have entered the industry and then left it again through bankruptcy is a depressingly long one. All the evidence one could possibly require is there to illustrate the point that investing in and setting up a new airline is, at best, highly speculative, with an overwhelming likelihood of failure. From this, one might assume that new entry into the aviation industry would largely be a thing of the past, especially given the depressed state of the industry in the early years of the new century. Nothing could be further from the truth, with the pressure of entry seemingly as strong, or stronger, than ever. One explanation for this apparent contradiction is that aviation is seen as a glamorous and exciting industry by many, and that the dream to set up and own one’s own airline is a continuing one for those with large egos and deep pockets. Industries with dirty, unpleasant processes at their heart do not have the same appeal, despite the fact that profits and returns on capital may be much better within them. The English expression, “where there’s muck there’s brass” is a telling one.
As an overall conclusion to the question of entry, incumbent airlines must prepare themselves for a continuing challenge from new entrants, especially in their short-haul, point-to-point markets.

4:1:4 Power of Customers

Porter argues that the power of their customers will be a crucial determinant of profitability for the firms in any industry. In turn, customer power will be related to two variables: the number of customers a firm has, and the existence – or otherwise – of so-called Switching Costs.

In principle, the point about the number of customers is an obvious one. If a firm has many customers and some of these defect to the competition, there will still be a large number of customers remaining. If, on the other hand, the firm has only two or three customers, the loss of one of them will result in a third or more of its business being lost. In such a situation, customers will have extreme amounts of bargaining power. They will be able to cut deals on terms which are extremely favourable to them, holding down the profits of the companies from which they are buying.

Despite the unambiguous nature of this point, a series of industry trends during the 1990s suggested that airlines were ignoring it. They allowed the size of their customer base to decline steadily, with serious consequences for their profitability.

This decline resulted from at least three factors. Firstly, as we have seen, there was an increase in the extent to which firms in business travel were prepared to use their bargaining power to conclude corporate deals in which a degree of loyalty was traded for substantial price discounts. This changed the nature of the business travel market. Instead of the airline’s ‘Customers’ being the business travellers who actually flew, they were increasingly negotiating with a relatively small number of finance and purchasing people who had been given the responsibility of negotiating corporate deals.

The structure of the travel agency industry also changed during the 1990s. In many countries, life became harder for the smaller, independent agent. Instead, an increasing share of the market was held by large, often multinational, agency chains, who achieved substantial power as a result of their ability – often exaggerated, but still significant – to switch passengers between airlines according the commissions they were being paid.

Such a trend did not arise by accident. Many airlines adopted a policy of paying so-called over-ride commissions to agents according to the volume of business delivered to them. In the short term, such a policy gained them the greatest amount of revenue. It did, though, give important advantages to large travel agents who could meet their revenue targets for
over-rides. These agents were in turn able to use their higher commissions to fund market share battles against their smaller rivals, further cementing their domination.

A further issue regarding the size of the airline customer base concerned the selling of seats to price-sensitive leisure travellers. Again during the 1990s, many airlines tended to opt out of retail marketing of these seats. Instead, this job was increasingly left to so-called Bucket Shops and Consolidators, who treated the airlines as suppliers of cheap seats which in turn could be sold on, at a profit, through their own retail marketing outlets. Firms such as Trailfinders in the UK and Eupo-Air in the Far East achieved substantial dominance as a result. As they did so, they were progressively able to change their role from one of selling a small number of otherwise unsold seats, to one where they were able to dictate prices to carriers, negotiating deals which were very attractive to them, but which were much less so to the airlines supplying them.

As we shall see in section 7:2, the last five years have seen a revolution in the distribution channels used by airlines. The Internet has become a very important channel, and from the issues raised in this section, it is easy to see why. The Internet allows carriers to begin the process of broadening their customer base once again, and to make better contact with the true sources of their revenue. They are therefore able to address the problems of escalating commission costs and falling yields, which were a clear consequence of the mistaken polices of the 1990s.

A final question with the size of the airline customer base is in some senses the most worrying of all. Porter warns that if one, or a small number of the firm’s customers become too big, they may take the view that it would be more cost-efficient to take on the resources to do the job themselves. If they do, a firm may lose all of the large amount of business currently being obtained from a single source. Worse still, the former customer may decide that there is actually money to be made in the new area of activity. If it does, it will not only cease to supply business to the firm in question, but will actively begin to compete with the firm for its remaining customers.

In the aviation industry, a common situation where a customer turns into a competitor occurs when a tour operator grows bigger and bigger, giving larger amounts of business to existing charter airlines. Often, a point arrives where it will make sense for the tour operator to buy its own aircraft, in order to set up an airline to carry its own passengers and perhaps also the compete in the open market for other airlines’ passengers as well. The tax benefits associated with aircraft ownership can be an added incentive to do this, given that tour operators normally do not have significant capital assets to use to offset against their tax liabilities.
The subject of so-called Integrated Carriers is also an interesting one with regard to the question of customers becoming competitors. The subject of Integrators is covered fully in Section 4.4.2, but, in summary, they are freight companies specialising in the movement of relatively small, urgent, packages. When they begin service on a new route, it is normal for them to offer substantial amounts of business to existing combination airlines. This helps the Integrators to grow their traffic. Unfortunately for the combination airlines, once they have done so, it has been common practice for them to then put on their own specialist freighter aircraft, cutting out of the equation the airlines that first helped them to grow.

The question of Switching Costs is an equally difficult one. In some industries, there are very substantial costs associated with switching from one supplier to another. Airline fleet planning illustrated this point very well. An airline only using, for example, Boeing aircraft will have built up a large investment in Boeing spare parts, Boeing-orientated flight simulators, and in the training of its staff to be familiar with Boeing products. There will therefore be a strong financial incentive to continue to buy from Boeing. If Airbus is to break the stranglehold of Boeing at such an airline, they will have to offer very large discounts on the purchase price of their aircraft, in order to effectively pay themselves for the Switching Costs of moving away from Boeing. They will probably have to offer many other incentives as well, such as large amounts of free pilot training.

The problem for airlines is that they do not have the Switching Cost protection which assists aircraft manufacturers in retaining their customer base. An airline may be getting a worthwhile amount of business from a major customer as a result of having a corporate deal with them. It will be a simple task, though, for another carrier to come along and offer the customer a more attractive level of discount, with the result that the corporate deal with the first airline is cancelled and transferred to the second. This will be easy, because little capital investment or training is required to work with one airline rather than with another.

Of course, the first airline will hope that its Frequent Flyer Programme will be of some value in fending off predatory attacks by its rivals, in that many people who actually travel for the firm in question will wish to continue to build their mileage balance, and retain their privileged status, within the programme. Even this, very limited, Switching Cost protection can be addressed by the predator by a ‘Golden Hello’ tactic of giving out a large number of free miles and Gold Cards in their programme to these people.

Overall, the question of the Power of their Customers is a very difficult one for airlines to address, and goes a long way towards explaining the poor profit performance of many carriers in recent years.
This depressing conclusion is equally applicable to Porter’s remaining point, that of the power of a firm’s suppliers.

Porter argues – again, the point is straightforward – that when a firm is totally dependent on monopoly suppliers of crucially-needed resources, these suppliers will be able to charge prices which ensure handsome profits for themselves, but which severely limit profits of the firms that they supply.

For airlines, the list of suppliers who either actually or potentially have this monopoly power is a depressingly long one. Most obviously, suppliers of Air Traffic Control and airport services may have it, with many airlines having no choice but to pay whatever ATC and airport charges are levied on them. It is most noticeable that at the time of writing airline profits have been severely affected in a major industry downturn, but the pain of this is not being evenly distributed across the industry. Many airports are continuing to show strong financial returns, reflecting the monopoly power that many of them have. Often, it has been necessary to regulate landing fees in order to control the use of this power.

Sometimes, airlines’ fleet planning can be affected by powerful supplier issues. The Boeing 747 was introduced into airline service in 1970, and was unchallenged by any other aircraft for the next 25 years. If a carrier’s requirement was a long-range aircraft with 400+ seats, the 747 was the only option available to them. Not surprisingly, the aircraft became a very profitable project for Boeing. In the future, a similar situation may develop with the 555 seat Airbus A380, though Boeing’s recent decision to launch a stretched version of the 747 – the so-called 747-8 – will have been greeted with a sigh of relief by many airlines.

Perhaps the best, and most controversial, example of powerful suppliers in the aviation industry has concerned the so-called Global Distribution Systems (GDSs).

Since their inception in the late 1980s, the GDSs have provided the switching technology which allows travel agents to make reservations with hundreds of different airlines, hotels, car rental companies and tour operators through a single computer keyboard.

Unlike airlines, the GDS business is one of immense scale economies. The capital costs of entering the business have been very high, but running costs have been low. Large firms have therefore been able to spread their capital costs over greater volumes of output and achieve lower unit costs. As a result, there are only four significant players in the global GDS industry – the US based SABRE and Worldspan, and European-originating Galileo International and Amadeus. (In December 2006, a plan was
announced for a merger between Galileo and Worldspan). All were first set up by airlines or consortia of airlines, though in recent years their ownership has become more diverse. (Very recently, some new entrants, using a different business model, have appeared in the GDS industry. This is a development which we will cover fully in Section 7:3)

Besides strongly concentrated patterns of ownership, the GDS industry has also shown a trend towards the establishment of geographical monopolies. For example, a high proportion of travel agents in the UK use Galileo. An equally high proportion in France and Germany are Amadeus customers.

The GDS companies do not, of course, provide their services free. When they were first proposed, the plan was that the costs associated with them would be shared equally between travel agents and airlines. Travel agents would pay substantial rent to the company which supplied them with a GDS service, reflecting the fact that the GDS allowed them to substantially increase the productivity of their staff. Airlines and other travel firms would pay their contribution to GDS costs through a booking fee payable on each booking made in their reservation systems.

It has not worked out in this way. Because of the Economies of Scale involved, the GDS companies saw it as a major business objective to increase their market share in order to boost transaction volume. They did so by engaging in aggressive pricing, so aggressive in many cases that travel agents were given a GDS service free-of-charge if they switched from one firm to another, or even received incentive payments for doing so.

The result of such a policy has been that the costs of GDS fell disproportionately on airlines, with the current level of booking fee they are paying being between $4 and $4.50 per passenger. This may seem a trivial amount, until it is multiplied by the hundreds of millions of passengers carried by the world’s airlines each year.

Not surprisingly, such a situation has been regarded as totally unsatisfactory by many airlines, particularly by those which have not benefited by having a shareholding in a GDS. Until recently, though, it has been difficult for many of them to do much about it. Some carriers, such as the UK firm Easyjet, have from the beginning adopted a radical policy of direct selling, completely by-passing the travel agency distribution system. Besides avoiding commission payments, this policy has also allowed the airline to save on GDS booking fees. This has been something of great importance to a low fares airline given that booking fees are levied on each booking made and thus potentially make up a disproportionate amount of cost for such an airline.

For traditional carriers, the travel agency system has overwhelmingly been their main channel of distribution, with 85 – 90% of their bookings
coming from this source. They have not, therefore, been able to refuse to pay GDS booking fees. Had they done so, the GDS firms would simply have removed the schedules and fares information of the recalcitrant airlines from their database, with the result that almost all the bookings they might have received from travel agents would have been lost. Therefore, in Porter terms, the GDS companies were monopoly suppliers of vital resources, and it should have come as no surprise that during the 1990s they were highly profitable. It should equally be of no surprise that as soon as the Internet offered a viable alternative distribution channel, airlines would embrace it enthusiastically. This whole, very controversial area will be reviewed further in Section 7:3.

4:1:6 “Disintermediation”

Sometimes, in the application of the Five Forces model, situations arise where relationships between firms change radically. This is especially likely when a particular player or group of players is not adding sufficient value to justify the prices that they are charging. An attempt may then be made to bypass them, in a process which Porter describes as Disintermediation. Two examples, one actual and one potential, illustrate this process in the aviation industry. Returning to the example of the GDS firms given above, the recent rapid growth in the use of the internet as a distribution channel reflects a clear attempt by airlines to disintermediate the GDS companies, one which has already saved them substantial amounts in terms of booking fees.

Another interesting case comes from the freight side of the industry. In recent years, a number of companies have grown up which have specialised in providing so-called wet-leasing services for large freighter aircraft (mainly the Boeing 747F). The American firm Atlasair is the most notable of these. By using their services, an airline can offer its customers main deck freight capacity, without the costly overheads of owning and operating freighter aircraft themselves. In particular, they can save money because Atlasair crew salaries are generally very much lower than the often stratospheric rates of pay given to 747 crews by traditional airlines.

The potential problem of such policies is, though, very clear, in that the airlines using wet-leased freighters are adding very little value. Mostly, they are taking pre-loaded Unit Load Devices (ULDs) from air freight forwarders, and loading these onto the wet-leased freighters. Sooner or later, the freight forwarders may decide that it will be more profitable for them to wet-lease the freighters themselves, and employ local handling agents to perform the simple task of dealing with the pre-loaded units.
Indeed, one forwarder, the Swiss-owned Panalpina, is already doing so. Each time they do is a classic case of Disintermediation.

Overall, Porter’s Five Forces model provides a valuable backdrop against which to view airline strategic decision-making. Any airline strategy, if it is to be successful, must deal with a complex interplay of often conflicting forces.

4:2 Strategic Families

4:2:1 Cost Leadership, Differentiation and Focus – The Principles

Figure 4:1 presents a diagram, again taken from Porter’s “Competitive Strategy”.

In it, Porter argues that some firms achieve success from what he calls Cost Leadership position. Others employ a strategy based on Differentiation. A third option is to adopt a Focussing position, though here, the focussing expertise may be used either to add value, or to achieve low production costs. Porter also argues that there is a fourth position, called Lost-in-the-Middle, from which success is difficult or impossible.

<table>
<thead>
<tr>
<th>Strategic Advantage</th>
<th>Uniqueness perceived by the customer</th>
<th>Low cost position</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>STRATEGIC TARGET</strong></td>
<td>DIFFERENTIATION</td>
<td>OVERALL COST LEADERSHIP</td>
</tr>
<tr>
<td>Industrywide</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Particular Segment Only</td>
<td></td>
<td>FOCUS</td>
</tr>
</tbody>
</table>

Figure 4:1 Sources of Competitive Advantage

The diagram is not above criticism. In particular, it suffers from the weakness inherent in any two-by-two format, of attempting to place things in discrete boxes when more normally, relationships are ones of continuum or spectrum. Also, as Porter has recognised in his subsequent writing, a corporate entity may be represented in more than one box as a business becomes larger and more diversified. Finally, in the airline industry, for many years the model failed to work well because government regulation of competition distorted the free interplay of market forces.

Despite these limitations, the model is now a very powerful one in understanding the strategic options open to firms in today’s airline industry. In particular, as the forces of deregulation and liberalisation have advanced over the last fifteen years, so the model has fitted the circumstances of the industry better and better.

In order to make use of the model, it is first of all necessary to understand the meaning of the terms contained in it.

A Cost Leader firm has a set of clear requirements it must satisfy if it is to be successful. Firstly, it must achieve, and then sustain, significantly lower operating costs than its rivals. If it loses its cost advantage, it will be in serious difficulties. Secondly and crucially, it must correctly identify what its customers are prepared to give up, and what they are not prepared to give up, in order to gain access to cheap prices.

There are many examples of firms which do successfully achieve these requirements. Interestingly, (in terms of traditional thinking in the airline industry), such firms are often highly profitable, despite the low prices which they charge.

In the world of supermarkets, the German firm Aldi has achieved a great deal of success, now having branches in many European countries. This success has been based on the remarkably low prices which it charges. Those shopping at Aldi have to accept, though, that sacrifices will be required if they are to take advantage of the very cheap prices on offer. Choice may be limited, display standards poor, and check-out queues long. There is no loyalty scheme available and even the plastic bags into which shopping is packed are charged for.

In another sector, IKEA is a successful firm in the field of furniture retailing. Again, prices are keen and attractive, but major sacrifices have to be made to obtain them. In particular, most of their furniture is supplied in flat-pack form, with the purchaser required to assemble what they have bought themselves. This condition permits IKEA to make major savings in labour and storage costs, and judging by the firm’s growth, is something which its customers accept.

A final example of successful Cost Leadership comes with cheap motel chains such as Travelodge. These chains make available rooms at a very
attractive rate. Those using them, though, have to make sacrifices to gain access to cheap prices. The room often has to be paid for on arrival rather than on departure. It may be rather small, and may not have a telephone. Sometimes, the motel does not have its own restaurant, requiring patrons to walk to a nearby fast food outlet. Generally, though, the rooms do have a private bathroom – albeit a very small one. Going without a private bathroom is an example of a sacrifice which most people are not prepared to countenance. If bathrooms have to be shared, the motels would be less popular, even if, as a result, prices could be even lower.

In a sense, the concept of Differentiation is a harder one to analyse, in that there are potentially many ways for firms to successfully achieve differentiation. However, perhaps for our purposes, the UK firm Marks and Spencer is a good illustration. Marks and Spencer has been through some difficult times recently, and to some extent has been knocked off its pedestal. For many years, though, it was a great success story.

The secret of Marks and Spencer’s long-term success did not come from it being recognised as the cheapest place where one could buy food, clothes or household goods. Rather, it prided itself on occupying the Value-for-money high ground. Quality standards were high and proven, and an unequivocal guarantee was given that purchases could be exchanged or the money paid for then refunded if they failed to please.

From the point of view of the airline industry, as we shall see shortly, one of the most interesting aspects of the success of Marks and Spencer (or, for that matter, the British firm Tesco or the French Carrefour) is their very successful exploitation of synergies in order to achieve Differentiation. If a store is stocking 30,000 or more products under one roof, there is a very good chance that, once customers, have entered the store, they will end up buying more than they had originally intended, due to the range of goods on offer. In aerospace, much the same can be said for aero-engine companies such as Rolls-Royce. Rolls defines itself as being in the Power business, and supplies turbines for power stations, ships and military aircraft, as well as for civil airframes. By being in all these sectors at the same time, Rolls presumably hopes that synergies will be available in such areas as research and development expenditure.

The concept of Focussing is one where a firm chooses to give up all these potential benefits of synergy by concentrating on one activity. Their aim is to achieve such expertise in this one area that they will be able to hold off the challenge of those who are benefiting from synergies in either the Cost Leader or Differentiation sectors.

By way of illustration, a fashion in the UK at the time of writing is for ethnic – particularly Indian – food. In response, specialist grocery stores are growing up which only sell Indian grocery products. They therefore
have none of the synergies available to Tesco or Marks and Spencer. They achieve such strength, though, from their exclusive focus of activity that they are able to hold off the supermarket’s competitive challenge. Tesco does have a good Indian food section, but it cannot be as comprehensive as that available in a store which lives or dies by its ability to meet the demand for Indian ingredients.

Of, such a positioning also illustrates the danger of a Focussing approach. If fashions change and Indian food loses its appeal, the firm supplying such food will be in a very difficult position.

Lost-in-the-Middle is, as we have said, a situation where a firm is in none of the major boxes. In many countries the small village store represents this position. As car ownership has grown, it has become commonplace for people to drive to an out-of-town hypermarket, rather than patronise the local store in the town or village where they live. In fighting back, the owners of village stores have few weapons at their disposal. They will not have the buying power of an Aldi which would allow them to offer very low prices, whilst they cannot stock the 30,000 or more items typical of a hypermarket. Finally, there would be insufficient demand in a small town or village for a store which specialised in a narrow area such as Indian grocery products.

The Lost-in-the-Middle nature of the village store’s position is illustrated by the fact that over the last ten years, many of them have been forced to close. As we shall see, many medium-sized airlines are likely to follow them in the years to come.

4:2:2 Cost Leadership in the Airline Industry: Background

The concept of Cost Leadership strategies is by no means new in the airline industry. In 1971, a new carrier, Southwest Airlines, was set up (after a series of drawn out legal battles instigated by incumbent carriers), to serve the intra-state Texan market in the USA. The airline became profitable in 1975, and, remarkably, has stayed profitable ever since. It has remained in the black even during the recessionary periods of 1991-94 and from 2000 until 2005, when the losses made by almost all the other airlines in the USA were very large indeed.

It has been the period since the late 1990s that has seen the rapid spread of the use of Cost Leadership strategies around the world. We now have two large, and rapidly growing airlines employing it in Europe,
Ryanair and Easyjet, as well as many smaller new entrants. A new airline, Jetblue Airways, has appeared in the USA, and has made a successful beginning. This has been no mean feat considering the sea of red ink which engulfed the US airline industry during its early years. Other examples of new entrant Cost Leader players around the world include Westjet in Canada, Virgin Blue in Australia, Gol in Brazil and Air Asia, a domestic and regional carrier in Malaysia.

Besides these existing players, a high proportion of the start-up proposals being put forward at the present time include Cost Leadership elements in them.

It is instructive to ask the question why recent times have seen this explosion in the use of Cost Leadership strategies, when the success of the pioneer, Southwest, had been obvious for many years.

Regulatory liberalisation is one obvious explanation. The agreement for the setting up of the Single Aviation Market of the European Union in 1993 (and the subsequent completion of the liberalisation process in 1997) gave opportunities for new entry which never existed before. Liberalisation of other domestic markets – notably those of Canada and Australia – has also been helpful in allowing start-up entrepreneurs to fulfil their ambitions. It is notable that those markets which have so far seen the least development of Cost Leadership – for example South East Asia – are also still amongst the most regulated.

The arrival of the Internet as a channel for airline distribution has also been highly significant. Until the late 1990s, distribution was both challenging and costly for airlines, which were mostly forced to rely on one channel of distribution, that provided by the travel agency industry.

The Internet has changed this situation beyond all recognition. For carriers that have been prepared to break with the past and simplify their fares and reservations procedures, the Internet has provided a route to speedy and cost-effective distribution. In using it, airlines have been further helped by the introduction of electronic, rather than paper, ticketing.

The changing nature of the business air travel market provides a final and interesting explanation for the growth of Cost Leadership strategies. Until the late 1990s, traditional carriers were greatly favoured by the fact that business travellers generally paid high prices for expensive, but prestigious travel in Business Class on board airlines which dedicated a great deal of effort to meeting a range of needs centred around prestige and status.

Some of them are still prepared to do this, but a number of changes have now taken place. As we discussed in Section 2:3:3, recent years have seen an increase in the importance of the so-called “Independent” business traveller. These are people who work for themselves or for small firms,
and who feel that the price of an air ticket comes out of their own pocket. Even in the corporate travel market, business travellers are being forced to become more price-sensitive by the corporate purchasing of business travel, whereby companies trade lower fares for loyalty. Even travel agents now join in the quest for lower fares as they seek to prove their ability to get value-for-money, in order to retain their increasingly demanding corporate clients.

Whatever the explanation, the interest being shown around the world in Cost Leadership strategies now makes this the most important strategic development in the industry for many years.

4:2:3 Fundamentals of the Business Model

The business principles that underlie Cost Leadership need hold no terrors for the analyst. They are now very well understood, and remarkably straightforward.

Underlying all these principles is one fundamental philosophy – that of simplicity. Some of the world’s most successful and profitable businesses have taken processes which from the point-of-view of the user were complicated, and simplified them.

Outside of the aviation industry, computing provides a good example. Thirty years ago, the use of computers was restricted to a relatively small and highly trained group. Today, computers are used by almost everyone, because software firms such as Microsoft have taken most of the mystique and difficulties away. The result has been a remarkable virtuous circle. Growing demand for PCs and laptops has led to very large economies of scale in production, which have in turn allowed for further price reductions.

Coming to the airline business, the example of so-called Integrated Carriers is instructive. We will cover these firms in detail in Section 4:4:2, but for the moment what it is important to note is that before their arrival, using air freight for a small urgent package was a complex task, only accessible to experts. Traditional airlines were only interested in the relatively easy job of moving shipments from airport to airport. This left the shipper to make arrangements for collection and delivery, documentation (in itself no mean task in view of the complexities inherent in the documentation requirements dreamed up by airlines) and customs clearance. The result was that large firms called air freight forwarders, grew up to handle air freight shipments, because lay people could not undertake the task themselves. Over the years, forwarders have cost airlines immense sums in commissions and in the consequences of reduced market control.
The situation today for the non-expert who has a small package needing air transportation is very different. Integrated carriers – for example, DHL, FedEx, UPS and TNT – all offer a collection and delivery service. They have simplified documentation, so that non-expert people can easily complete it, and arrange customs clearance. For added peace-of-mind, they also have a comprehensive tracking and tracing service available over the Internet.

The result has been exactly as one would expect. The market for small, urgent packages – the so-called “Express” market – is the fastest growing part of the air freight market. The growth, though, is not benefiting the traditional airlines very much with the complicated demands which they place on the customer. Rather, the market share of the Integrators is steadily increasing, allowing them to further reduce their prices as they benefit from the substantial economies-of-scale inherent in small package operations.

If we turn now to the strategies of traditional airlines on the passenger side, the importance of simplicity – or, rather, the lack of it – becomes clearer still. This is best illustrated in the area of pricing policy. To the passenger, the question “What will the fare be?” for a given journey on a given day, seems to be completely straightforward, but airlines have been incapable of giving a straightforward answer. Often, fifty or more fares are available on a given route. Which one the passenger will actually be able to use will depend on their ability to satisfy a range of conditions around such things as advanced booking, length of stay and cancellation/rebooking opportunities.

The consequences of such complexities are severe. They make the training of new reservations and ticketing personnel a costly and time-consuming process. Even more so, the point-of-sale task becomes a slow and complex one. This in turn often forces the consumer to turn to a travel agent to unravel the complexities, involving airlines in the same commission and market control issues which have arisen on the freight side with air freight forwarders. In turn, the build-up of business obtained over the Internet has been much slower for traditional airlines than it has been for new entrant Cost Leader players with their simple fare structures.

Overall, achieving and sustaining simplicity in business processes is an absolutely fundamental requirement for a successful Cost Leadership strategy. Bearing this point in mind, let us now explore further features of the strategy:

1. **Low Fleet Costs**

Most successful Cost Leader airlines today are pursuing a so-called “Fleet Commonality” policy, having only one type of aircraft in their fleet. In
turn, for many, this one type is the various members of the Boeing 737 family. Whatever this aircraft may now lack (at least according to Airbus) in passenger appeal and the use of the latest technology, it has rugged and proven reliability as its greatest asset. These are exactly the qualities needed by a Cost Leader airline, and both Southwest Airlines (with a fleet now consisting of more that 400 737s) and Ryanair illustrate very well a commonality policy with 737s. By sticking to one type of aircraft, they are gaining substantial economies in such areas as pilot training and maintenance.

Other Cost Leader airlines are pursuing different fleet strategies, but still with the aim of securing low costs. Easyjet began as a 737 operator, but in 2002 signed a very large deal for the acquisition of A319s, a smaller version of the A320. One must assume that the deal offered by Airbus was so attractive that it led the airline’s management to conclude that lower acquisition costs would outweigh the costs associated with a mixed fleet. The airline will also be in a good position to play one manufacturer off against the other when it comes to the question of new aircraft acquisitions in the future.

2. Low Landing Fees
Section 4:2:1 showed that the key to successful Cost Leadership was for a firm to establish and sustain a cost and through that, pricing advantage over all its rivals. In order to do so, it must address the “big ticket” cost items, those which will have a substantial impact on unit costs.

Table 4:1 presents cost data for British Midland Airways, a short-haul airline providing a conventional service on UK domestic and regional routes. The cost information is broken down on a departmental cost basis. It shows that landing fees and passenger embarkation charges are a major cost item, accounting for nearly 18% of costs. Any airline which can substantially reduce them will have taken a very successful first step towards a sustainable Cost Leadership position.

Southwest Airlines illustrates the principle well. Throughout its history the airline has pursued a policy of seeking out unused or little-used airports, even if these are old, sometimes dilapidated and unfashionable. At its home base, Dallas, it uses Dallas/Love Field airport, rather than the much larger DFW. At Chicago, it flies to Midway, rather than O’Hare, whilst in the New York region the relatively remote airport of Islip, on Long Island, is used rather than the congested and expensive Kennedy, Newark or Laguardia.
Table: 4:1 British Midland – Cost Structure: Financial Year 2003/04

<table>
<thead>
<tr>
<th>Cost Category</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Depreciation and Rental</td>
<td>14.5</td>
</tr>
<tr>
<td>2. Handling Costs, Parking Fees &amp; Station Costs</td>
<td>10.8</td>
</tr>
<tr>
<td>3. General &amp; Administrative</td>
<td>5.8</td>
</tr>
<tr>
<td>4. Landing Fees, Passenger Embarkation Charges</td>
<td>17.6</td>
</tr>
<tr>
<td>5. Flight Crew Costs</td>
<td>6.7</td>
</tr>
<tr>
<td>6. Maintenance &amp; Overhaul</td>
<td>10.3</td>
</tr>
<tr>
<td>7. Aircraft Fuel &amp; Oil</td>
<td>10.5</td>
</tr>
<tr>
<td>8. Commission</td>
<td>2.9</td>
</tr>
<tr>
<td>9. Passenger Services</td>
<td>3.8</td>
</tr>
<tr>
<td>10. Cabin Crew Costs</td>
<td>3.6</td>
</tr>
<tr>
<td>11. Navigation &amp; En Route Charges</td>
<td>5.0</td>
</tr>
<tr>
<td>12. Reservations</td>
<td>3.5</td>
</tr>
<tr>
<td>13. Advertising &amp; Promotion</td>
<td>2.8</td>
</tr>
<tr>
<td>14. Sales</td>
<td>0.8</td>
</tr>
<tr>
<td>15. Specific Cargo Costs</td>
<td>1.3</td>
</tr>
<tr>
<td>16. Insurance</td>
<td>0.8</td>
</tr>
<tr>
<td>17. Other Operating Costs</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: CAA.

In Europe, Ryanair pursues such a policy in an even more exaggerated fashion. Indeed, the airline has stated that in its route expansion policy, the existence of an underutilised airport, even if it is a long way from the city it purports to serve, is the most fundamental requirement.

The benefits of using underutilised airports are very great. The airline gains from very low landing fees, as airport operators reason that they are better off having substantial numbers of passengers (who will, in turn, provide commercial income for the airport from such activities as car parking and shopping) rather than none at all. It will also be able to expand rapidly, free of the slot-availability constraints that bedevil congested hubs.

Interestingly, at the present time, not all Cost Leader airlines are sticking to the “pure” form of the model with respect to airport selection. In strong contrast to Southwest, Jetblue Airways has based itself at Kennedy Airport In New York. Easyjet is making use of some congested European airports – notably Gatwick, Schiphol and both Orly and CDG airports at Paris, though the airline has shown itself to be particularly adept
at moving quickly when slots at such airports have unexpectedly become available.

3. Short Turnarounds/High Aircraft Utilisation

Once uncongested airports have been selected, the Cost Leader airline is well on the way to achieving its next requirement, that of short turnarounds and high aircraft utilisation. Southwest Airlines has always scheduled turnarounds of 20-25 minutes, in contrast to the 50 minutes to one hour which the industry has traditionally used. This greatly helps the airline in its aim of achieving low costs, because it allows additional rotations to be operated each day. In turn, this permits a wider spread of capital costs (in the case of aircraft which are owned), or of lease rentals.

Of course, short turnarounds are not the only requirements. These turnarounds must be engineered so that they can be achieved consistently – otherwise an unacceptable punctuality penalty will result. Thus, for example, most Cost Leader airlines do not use airbridges at airports, despite the fact that this leaves their passengers unprotected in wet or cold weather. The benefit of this is that it allows both the front and rear aircraft exits to be used, speeding passenger enplaning and deplaning. Controversially, many Cost Leader airlines do not pre-allocate seats. This leads to jibes about “Cattle Truck Handling” as passengers rush for the seats they want when the boarding process begins. It means, though, that passengers are far more likely to be at the gate at the boarding time, and that they can be encouraged to sit down by the cabin crew in any available seat once they are on the aircraft.

As a further point, the fact that Cost Leader airlines are generally “no frills” (see below) makes galley servicing a very easy and quick process, as is cabin cleaning. Indeed, many Cost Leader airlines require their cabin crews to clean the aircraft during daytime stops, with a thorough clean only being given overnight. This will not be possible for full service airlines where food and other debris will be more of a problem (and trade union resistance highly likely).

4. Limited On-board Service

The data presented in Table 4:1 is instructive, in that it shows that a short-haul airline, British Midland, spends 3.8% of its costs on “Passenger Services” – the meals and drinks given away free to passengers.

It might at first sight be assumed that Passenger Service costs would only be high for long-haul airlines, where passengers need to be offered generous hospitality because of the length of time they are on board the aircraft. This is not so. Traditional short-haul airlines (especially in Europe) have given passengers a complementary drinks and meal service,
even on flights with a duration of only an hour or so. The costs of doing so can then only be spread over a small number of passenger-kilometres, and therefore have a disproportionate impact on unit costs.

Cost Leader airlines have a choice to make with respect to on-board catering. Some have chosen to be completely “no-frills”. This allows cheaper aircraft acquisition costs due to the absence of galley space, speeds aircraft cleaning and allows extra seating. Others – in fact, today, most of them – do offer a meals-and-drinks service, but charge relatively high prices to what are captive customers. Passenger service then becomes a worthwhile source of so-called ‘Ancillary’ revenue rather than a cost item.

5. Point-to-Point Only
One of the most important, but more overlooked, reasons explaining the recent success of the Cost Leader model is that airlines using it have concentrated on point-to-point traffic, eliminating what has hitherto been an unacceptable level of cross-subsidy from point-to-point to connecting passengers.

Any airline offering a transfer and connections product at a hub will incur substantial additional costs. Passengers checking in for a connecting flight will expect to be given a boarding pass not only for their first sector, into the hub, but also for their onward flight. Providing such a service will involve the airline in significant investment in its data processing and communications capability. Passengers will also assume that they can check-in their baggage at their point-of-origin, and reclaim it only at their final destination. All interim baggage handling will be taken care of by the airline, at a substantial cost. Once they reach their hub airport, they will expect to wait for their onward flight in a comfortable and well-appointed lounge.

Important though these costs are, the provision of a connecting product will have still wider – and greater – cost implications. Implicit in the idea of hubbing is that flights will be co-ordinated in banks, so that connections can be made in the shortest possible time. These banks require a peak availability of resources, resources which will be poorly utilised as soon as the peak is over.

The costs of a connections product would be a severe problem in themselves. The problem is made worse, though, by the low yields often obtainable from transfer traffic. A passenger making a connection will generally have a worthwhile choice available to them, because they will be able to travel via the hubs of a range of different airlines. Carriers know this, and will try to entice the passenger to choose their hub rather than that of a rival. Yields are therefore generally poor in the market of transfer traffic.
In the past, traditional airlines have been able to compensate for these low yields by charging disproportionately high prices to people travelling on a point-to-point basis, for whom the hub serves as a local airport. The result has been that it has commonly been cheaper to fly from a point behind the hub, into the hub and then beyond, than it has been to travel on a point-to-point basis. Such absurd and discriminatory pricing practices have led to so-called Cross-Border Ticketing, an “abuse” which airlines have repeatedly tried and failed to eliminate.

Cost Leader airlines have removed all the costs and revenue dilution associated with a transfer product by concentrating exclusively on point-to-point traffic. It is, of course, possible to transfer from one flight to another on these airlines, though the fact that the emphasis is placed on high aircraft utilisation rather than the scheduling of banks of flights makes connecting opportunities less likely. Nothing is done, though, to assist the connecting passenger. When they reach their transfer airport, they will have to reclaim their own bag, and take it to the check-in desk for their onward flight themselves. No luxurious lounges are, of course, provided. With fares and yields, there is no dilution, because the airlines follow a “Sum-of-sector Fares” pricing principle, rather than the complex “Pro-rating” procedures we will describe in section 6:2:1.

6. Simple Fares
Cost Leader airlines follow significantly different pricing practices from traditional airlines in other ways as well. As we saw earlier in this section, the disciplines of Revenue Management have led airlines in the direction of greater pricing complexity, with often fifty or more fares being on offer on a particular route, most of them having different, and confusing, conditions associated with them.

Cost Leader airlines do make use of Revenue Management techniques, but generally with one crucial difference compared to traditional carriers. When someone looks at the website of one of these airlines, at the time they do so there is only one fare on offer for the flight in which they are interested. They are therefore faced with a clear “take it or leave it” choice. The fare on offer will certainly vary through time, being generally low well in advance of flight departure and rising as the departure day nears. The fact that there is only ever one fare available at a particular time makes the whole reservations procedure a very simple one, and, as we move onto now, allows the internet to be the cornerstone of distribution.

7. Low Distribution Costs
Section 7:2 gives full coverage of the changing world of airline distribution.
We will see there that the 1990s saw a rapid and unacceptable increase in the distribution costs of traditional airlines. This was due to the overwhelming domination of one channel of distribution – that provided by the travel agency industry. This near-monopoly caused a rapid increase in the commissions being paid to travel agents, as well as seeing airlines very vulnerable to the pricing practices of the Global Distribution Systems.

Any airline seeking a Cost Leadership position must address the question of distribution costs. If it can eliminate travel agents’ commissions, a major step will have been taken towards the establishment and maintenance of a cost advantage, especially when it is born in mind that by the end of the 1990s it was common to find that 12% - 14% of a traditional airline’s costs were made up of commissions.

In some sense, the elimination of GDS booking fees has been even more important for Cost Leader airlines. As we saw in Section 4:1:5, the GDS companies have always charged on a flat rate basis, currently about $4.50 per booking made. This is a reasonable policy given the structure of their costs, but it means that booking fees fall disproportionately on low fares carriers. $4.50 on a Business Class return fare of $3000 is an irrelevance. The same booking fee on a $50 fare most certainly is not.

The answer to the distribution problem for Cost Leader airlines has, of course, been to use the Internet. In this regard, the UK airline Easyjet has been the pioneer. From its foundation in 1995, Easyjet has paid no commission to any travel agent, and, because of this, no booking fees to any GDS company. The cost savings it has achieved as a result have been immense.

Easyjet has been followed by the airlines set up before it – Southwest and Ryanair – which have progressively eliminated the use of travel agents, and now have almost as high a proportion of their seats sold direct as Easyjet. Later entrants into the market have almost totally relied on internet-based direct sales.

8. Non-Refundable Tickets
In the past, most airlines have had a policy of making their more expensive tickets fully refundable. This makes them very much more attractive, especially for the business traveller whose exact schedule cannot be predicted very far in advance. It means, though, that these airlines have always had a significant no-show problem, which they have resolved, to a degree, by overbooking.

All the Cost Leader airlines have a policy of allowing no refunds. Bookings can be changed, in return for a substantial fee (in the UK, generally £25 plus any difference between the fare already paid and the current fare available on the flight to which the booking is to be transferred)
but no money is ever refunded. This allows the airlines a better and more certain cash flow, which in turn brings useful savings in interest costs.

4:2:4 Cost Leader Airlines: Current Issues

We have now looked at the different policies which airlines in the Cost Leader sector pursue. They illustrate perfectly Porter’s principles of Cost Leadership set out in Section 4:2:2. Successful players have to establish and sustain a cost, and through that, pricing advantage over their rivals. They must also correctly identify what their customers will, and will not give up to gain access to cheap prices. Cost Leader airlines have discovered that their customers will give up, amongst other things, service from their ideal airport, complementary meals and drinks, seat selection, the opportunity to buy a ticket through a travel agent and ticket refunds. The consequences of such policies, if correctly applied, are remarkable.

Cost Leader airlines seem to be the ones which have found a way round the chronic airline industry problem of cyclicality. As we will see in Section 4:3:1, the business model of Differentiation in the airline industry has generally allowed carriers to make reasonable returns in the buoyant upswing periods of the Trade Cycle. It has left them hopelessly exposed, though, in slow-down and recessionary times when large parts of the high yielding Business Class market – on which these airlines depend – has evaporated.

The Cost Leadership position, though, addresses such issues through what appears to be a virtuous circle. Low costs allow for profitable lower prices, which in turn substantially increase the size of the market. In times when the economy is strong, this market growth comes from new passengers being brought into the market who would not otherwise have flown. In times of slowdown or recession, Cost Leader airlines also appear to gain as people who are still anxious to fly trade down from the full service airlines as they seek lower prices.

A controversy currently affecting the Cost Leader sector is the question of the importance of customer service standards. The Cost Leader pioneer, Southwest, is a remarkable airline in that despite the fact that it is now a very large and mature carrier, it has retained a high degree of popularity with its passengers. The Department of Transportation in the USA collects, and publishes, data about passenger complaints, with the Major carriers being compared on the basis of the numbers of complaints received per 100,000 passengers carried. Southwest has been the airline with the lowest number of complaints for more than ten years, despite its “no frills” service. The secret seems to be that the airline makes a limited promise but keeps it consistently. It has also made great play on a warm and friendly
style of service, and a solid approach to customer service if things go wrong.

Amongst the other Cost Leader players, a different approach is apparent. Ryanair in particular, if media reports are to be believed, takes the view that customer service on the rare occasions when things go wrong is less important. Providing fares are cheap enough, people will mostly keep coming back. Those who desert the airline after experiencing a severe service failure will soon be replaced by new people brought into the market by the airline’s very low prices. It will be interesting to see which of these philosophies turns out to be the correct one in the long term.

Another major issue in Cost Leadership at the moment concerns the best way for a Cost Leader airline to be set up. Today, the successful Cost Leader players are all independent, in that they have been put together entrepreneurially, without links with any pre-existing airline. Given the profits that they have enjoyed in recent years, and the threat that they pose to longer-established airlines, it is not at all surprising that these “Legacy” airlines have adopted the philosophy that, “If you can’t beat them, join them”. A common way for a Cost Leader airline to be set up has been as a subsidiary of a full service carrier.

So far, little success has attended these efforts. During the 1990s, three of the US majors, United, Delta and USAirways set up low fares subsidiaries, using the branding of Shuttle-by-United, Delta Express and Metroair respectively. Within 4 years, each of these airlines had been closed down. In 1995, British Airways set up a Cost Leader subsidiary called Go. Presumably, the airline did not regard this carrier as a success, because it was eventually sold off (to its management, who then sold it to Easyjet), at what seems now to have been a very low price.

In recent years, there has been renewed interest in the idea of full-service airlines setting up low fares subsidiaries in order to try to compete with independent Cost Leader players. For example, Air Canada established two subsidiaries, using the sub-branding of Tango and Zip, to compete, presumably, with the very successful and rapidly-growing Westjet. Delta Airlines carried out a second attempt to enter the Cost Leader business with a new subsidiary branded Song. In Europe, British Midland set up BMI Baby, and SAS announced a Scandinavian no-frills airline under the Snowflake branding. In Australia, Qantas has set up its Jetstar operation, which at the time of writing seems to be faring quite well.

Some of these new initiatives may indeed be successful, but it is impossible to be optimistic. Air Canada has already closed down its Tango subsidiary, and Delta is merging its Song subsidiary back into its mainline activities. The essence of Cost Leadership is that firms are able to establish and sustain a cost advantage over their rivals. With low fares subsidiaries
of full service (and highly unionised) airlines, concessions may be given in a time of crisis which allow a lower cost base to be established. However, once things begin to improve, it often becomes a major objective of union negotiators to ensure that wages, salaries and conditions of employment at the subsidiary start to move nearer to those which prevail in the mainline operation. The cost advantages are then progressively eroded. Also, the setting up of a low fares subsidiary involves significant branding problems. When someone experiences no-frills service on a low-cost subsidiary it may colour their view of what will happen on their next flight with the full-service parent. Finally, low fares subsidiaries will perhaps allow an airline to compete more successfully with Cost Leader players which are challenging its dominance. Another, less desirable, effect is that the subsidiary may take traffic away from its parent, and lead to criticism of the parent’s relatively high prices.

4:2:5 Cost Leader Airlines: The Future

The question of the future of the Cost Leader sector is one of the most fascinating in the airline industry at the moment.

In answering it, it is first of all clear that Cost Leadership positions are much easier to establish and sustain in short-haul and regional markets than on long-haul. This is because many of the cost advantages we have been discussing as resulting from the Cost Leadership model are most marked there. The use of underutilised airports to lower landing fees and increase aircraft utilisation is an example. Landing fees are clearly a much higher proportion of operating costs in short-haul markets, whilst on long-haul, all airlines can achieve similar, high, aircraft utilisations. Shorter turnarounds do not allow extra rotations to be fitted into the flying day. A no-frills approach is a problem on long-haul, where a meals and drinks service will be regarded as more important by passengers spending many hours on an aircraft. Also a point-to-point only approach is less possible, with few long-haul markets having sufficient density on their own to be viable without hubbing. Finally, GDS booking fees, being charged on a flat-rate basis, are much less of a burden for the long-haul airline.

One could argue that the long-haul services mounted by many of Europe’s charter airlines in recent years amount to Cost Leadership in long-haul markets. However, in establishing and sustaining a cost advantage, these airlines have relied on low seat pitches – commonly 28 inches. Such a policy certainly has a dramatic effect on seat-kilometre costs, allowing 25% or more extra seats to be put on an aircraft compared with the more traditional pitches of 32 or 33 inches. However, we may now be getting to the stage where such a lack of seating comfort is becoming an unacceptable
sacrifice which people will not make. Sitting in such uncomfortable seating for many hours is not the same as it would be, for example, on a two-hour flight to the Mediterranean. Also, growing concern about Deep Vein Thrombosis means that airlines may leave themselves open to legal action if they continue to restrict seat pitches to such low levels.

Overall, it is likely that attempts will be made to spread the Low Cost Carrier concept onto long-haul routes – indeed, at the time of writing, the Canadian carrier Zoom, the Hong-Kong base Oasis Air and the Scottish airline Flyglobespan.com are all doing so. However, it is unlikely that these carriers and airlines like them will have the same dramatic effect on long-haul markets as Ryanair and Easyjet have had on short haul routes.

A further question for the future of the Cost Leader sector concerns safety standards. Safety is, of course, an absolutely fundamental concern for all airlines, but it has to especially be so for Cost Leader players. When tickets are extremely cheap, passengers must be wondering, perhaps subconsciously, as to why prices are so low. Do they reflect the fact that corners are being cut on safety?

Whilst the Cost Leader sector continues to enjoy a good safety record – for example, Ryanair has never had a fatal accident in more than fifteen years of flying – its growth will continue unabated. However, the experience of an airline called Valujet in 1996 was a salutary one. At the time, it was a successful and rapidly growing new entrant into the Cost Leader sector, but suffered a tragic fatal accident when one of its aircraft crashed in the Florida Everglades with a large loss of life. It never recovered, and was shortly afterwards taken over in a near-bankrupt condition.

At the time of writing, the major issue concerning the future of the Cost Leader sector concerns its explosive growth, and the large number of new entrants that are appearing.

Of course, the fact that the market is growing quickly would in any case be likely to induce a great deal of entry. In this regard, the Cost Leader sector is doing no more than illustrate the principles of the Product Life Cycle which we will further discuss in Section 5:2:1. However, there are particular factors at work at the moment, which are exacerbating “normal” Life Cycle effects. As we have seen, resources have been cheap, with leased aircraft plentifully available at low lease rentals. Also, in the short-haul markets where Cost Leaders operate there are few of the economies of scale which (through hubbing) to some degree protect existing players on long-haul. In long-haul, as we saw in Section 3:2:2, there are often still regulatory barriers to entry which protect long-established airlines against the threat of entry.
These things are important, but perhaps the biggest factor explaining the current explosion of entry into the Cost Leader sector at the moment, is that entrepreneurs are being drawn to it. It seems to be the one business model which offers the possibility of sustained profitability, in an industry otherwise often characterised by a sea of red ink.

The effect of all these factors is remarkable, and frightening. At the time of writing (summer 2006), many markets, notably so the UK, Germany and Scandinavia, are seeing a rapid pace of growth by existing Cost Leader airlines, and the setting up of large numbers of independent newcomers. At the same time, as we have just seen, many threatened incumbent airlines are introducing their own Cost Leader brands. Even where they are not doing so, they are having to lower the prices to compete with the newcomers, a development we will examine further in Section 4:2:7.

The result of all these developments will be to make the Cost Leader sector a volatile and unstable one over the next few years. It is true that the airlines in it will continue to be able to generate new traffic, but it seems inevitable that there will be significant problems of overcapacity as LCC markets, inevitably, mature. As a result, some of the high profits which are currently being made will disappear, and less well-managed firms will be forced to leave the industry. Those that remain, and succeed, will be those that apply Porter’s Cost Leadership model in its purest form. They will establish and sustain a clear cost advantage over their rivals.

The other issues concerning the future of the Cost Leader sector are mainly European, and stem from possible regulatory problems.

To achieve and sustain their success, Cost Leader airlines need very attractive deals from airport operators. To a remarkable degree, they have succeeded in obtaining these deals. Sometimes, though, the deals have been given to them by loss-making airports which are owned by local and regional governments and subsidised by them. This therefore raises the question as to whether or not the airlines, by an indirect routing, have received “illegal” State Aid. Ryanair was accused of doing so in its deal with Charleroi Airport in the south of Belgium and in its relationship with Strasbourg Airport. The result has been a new regulatory policy introduced by the European Commission to limit the scale and duration of payments from state-owned airports to airlines, and to ensure that deals are available to all airlines who might wish to take advantage of them, on a non-discriminatory basis.

Another current regulatory problem concerns the developing argument about Passenger Rights. During the autumn of 2002, a vigorous debate took place in the European Parliament about the need for airlines to compensate the victims of airline service failures – in particular those who
have experienced cancelled or delayed flights. Such compensation schemes would be in addition to those which already apply to a passenger experiencing Denied Boarding as a result of flight overbooking.

Not surprisingly, Cost Leader airlines mounted a strong lobby against such proposals. They argued, with reason, that a person paying a very low price should not be entitled to the same compensation as someone using an expensive ticket, which they would be under the scheme as it was currently proposed. However, their lobbying was not successful. New Passenger Rights rules have been introduced, and a challenge before the European Court mounted by two airline trade bodies (IATA and the European Low Fare Airlines Association) was rejected in January 2006. So far, though, the amounts of compensation paid out have been small.

A final regulatory issue concerns environmental taxation. In some senses, the Cost Leader sector is becoming a victim of its own success, in that it has produced often significant levels of traffic growth. This has in turn brought concerns to a head about the environmental impact of air transport, with the argument being put forward that the growth is only occurring because air passengers are not made to pay for the full environmental impact of aviation. If they are required to do so, through some form of additional taxation being imposed, it would certainly slow growth in the Cost Leader sector, especially if, as seems likely, it was imposed on a flat rate basis rather than as a percentage of the fare. The introduction of a scheme of Emissions Trading for aviation would have a similar, though almost certainly lesser, effect.

Overall, it is impossible to exaggerate the impact of the Cost Leader revolution on the air transport industry. Over the next few years, its implications will become ever more apparent in the markets where its effects have already been felt. It will also spread to hitherto unaffected markets.

4:2:6 “Differentiation” in the Airline Industry

Large numbers of airlines – mainly those which are long-established – in today’s airline industry do not seek out a Cost Leadership position for their mainline activity (though, as we have seen, increasing numbers of them have set up Cost Leader subsidiaries). Instead, their argument is that they provide a value-for-money solution to a wide range of customer requirements, exploiting the synergies which become available to a firm producing a range of different products under the same umbrella. Such policies conform very well to the “Differentiation” position of the Porter model described in Section 4:2:1.
In recent years, many airlines in the Differentiation sector have suffering chronic financial losses. This has been especially so amongst the airlines of the United States, and to a lesser extent, Europe. Indeed, in many cases, the term “Legacy Airline” is a good description of these carriers, as they have often seemed to be dinosaurs finding life difficult or impossible in a fast-changing world.

This dire situation has, though, only arisen relatively recently. Whilst financial returns in the Differentiation sector have never been good, the period from about 1996 until 1999 was as prosperous a time as many of them had enjoyed in their entire history. Indeed, at the time it did seem that a business model was becoming established which would allow, at long last, a sound and consistent return for shareholders. We need, firstly, to define this model, and then to come onto the difficult and painful question as to why, in a comparatively short time, it was so disastrously undermined.

In order to be successful in the Differentiation sector it has always been necessary for airlines to be innovative. Indeed it is not co-incidence that two of the most successful airlines in this sector, Emirates and Singapore Airlines, are also the airlines with a strong reputation for innovation. Both are early customers for the Airbus A380 large aircraft, and both have consistently aimed to be at the forefront of new developments in such areas as cabin comfort, in-flight service and in-flight entertainment.

Of course, over time, almost all innovations are capable of being matched by competitors and most of them are. However, Emirates and Singapore Airlines illustrate the concept of so-called “First Mover Advantage”, in that they have continued to reap the benefits of innovation even after matching by competitors has taken place. It seems that consumers continue to think well of a pioneer that took the risks and made the investment in an innovation which improves their lot.

Despite the importance of a product which matches the state-of-the-art, the standards of personal service which are offered assume even more significance for a Differentiation airline. As we have seen in Section 2:3:4, the business travel market – of crucial importance to Differentiation players – consists of a relatively small number of people, many of whom travel frequently over a long period of time. They get to know the airlines that give them a warm and caring welcome, and those which do not. Naturally, they prefer to travel, all other things being equal, with carriers which treat them well.

Personal service standards assume an even greater importance because they can provide a Sustainable Competitive Advantage. An airline may find that its standards of seating comfort, for example, have fallen behind those available on it rivals. If it does, it is then a straightforward, albeit costly, task to order and install the new seats which will correct the
anomaly. Things are not so straightforward if it has customer-contact staff who are ill-disciplined, poorly motivated and incompetent. Correcting such a state of affairs may take concerted action on many fronts over a long period of time. During this time, the airline will be losing out to its rivals if these competitors do not have the same problems.

Brand building forms another, vital, part of the business model for successful Differentiation in the airline industry. The subject of brands is fully covered in Section 8.2. For the moment, though, it is worthwhile to note that for many airlines, their problem is that they have become commoditised. Passengers tend to feel that all airlines are the same and that there are no strong reasons for choosing one rather than another. A small number of airlines do, though, manage to rise above such generalisations, and to achieve valuable status as a brand. The British carrier Virgin Atlantic is an example, in addition to Emirates and Singapore Airlines.

A further aspect of the traditional business model for Differentiation carriers is that they need to be well-represented in each of the major market segments, those of business travel, leisure travel and air freight.

Such a policy will bring with it the major disadvantage that the airline will be setting itself a complex management task, in which contradictions and compromises will be a major feature. However, the synergies available to the multi-product airline will often more than compensate. A presence in the business travel market will give an airline access to the highest yields, whilst the leisure market is the one which is producing the highest growth rates. Also, almost by definition, the business and leisure markets have complementary demand patterns, as when business travellers aren’t travelling because it is a holiday season, there will be a peak in leisure travel.

The synergies available from a strong presence in the air freight market are perhaps even greater. Belly-hold space in passenger aircraft will be cheaply available, and will also allow freight customers to benefit from the frequency and wide route network essentially provided for passengers. Air freight will help airlines’ cash flow during the times when passenger demand is affected by wars or a terrorism threat. Also, there is some evidence that air freight helps airlines respond to the challenges of the trade cycle, in that it tends to be affected by a recession earlier, but to come out of it sooner, than the passenger side of the business. It is not co-incidental that both Singapore Airlines and Emirates earn about a quarter of all their revenue from air freight.

Points about the importance of innovation, customer service, brand-building and a synergistic presence in all the major market segments have
always been true and remain so today. The other major issue with regard to
the business model for Differentiation airlines is more controversial.

During the 1990s a fashion grew up in the airline industry that “Big is
Beautiful” – that only airlines with a wide – preferably a global – network
had any real hope of survival in a rapidly changing world.

It is easy to see why such ideas should have arisen. In principle, an
airline with a wide network is better insulated against risk, in that it is
unlikely that traffic will turn down across the whole of a global network at
exactly the same time. Too many carriers in practice have their success or
failure linked to the fortunes of a single, or at least a small number, of
markets.

A wide route network also, by definition, allows airlines to offer a
greater number of “on-line” rather than “transfer” connections. An on-line
connection is one where the passenger uses the same airline both for the
flight into a hub and for the one beyond it. In the transfer case, two
different airlines are used.

All surveys of passenger preferences show that on-line connections are
preferred to transfer ones. People are more confident that they will get the
boarding passes for both sectors when they first check in, removing the
need for a visit to the Transfer Desk when they arrive at the hub airport.
They feel there is a greater likelihood of the baggage handling system
working, and their bag arriving at their final destination at the same time as
they do. They may hope that the gates for their two flights will be closer
together, avoiding the need for a long walk and, perhaps, an inter-terminal
transfer. Finally, they may be more confident that they will actually make
the connection, with greater efforts being made to help them if their
inbound flight is late.

Where an airline is too small to have a large number of on-line
connections, it has to fall back on the expedient of Code-Sharing. This is
where it lends its code to other airlines, or borrows theirs, so that
connections appear as on-line in Global Distribution System displays when,
in practice, they are nothing of the sort. Here, though, the downside may
be one of customer alienation if passengers end up flying on airlines they
would specifically prefer to avoid.

A final reason why big came to be regarded as beautiful in the airline
industry, was because of the introduction of Frequent Flyer Programmes.
In principle, the FFP of a large airline is more attractive than that of a small
carrier. Points can be earned more quickly, in that there is a greater
probability that an airline will have a service to all the destinations to which
a passenger will need to travel. Once they have been earned, redemption
opportunities for free flights will be greater, in that a wider range of
destinations will be available.
Given this range of factors, it was no surprise that the second half of the 1990s saw a trend towards consolidation, as a fashion for wide networks gripped the industry. However, there were strict limits as to how far such a trend could develop. In any “normal” industry, the quest for size would have meant entering new markets and significant amounts of merger and takeover activity. These trends – though they arose – were very muted in air transport because of the ownership and control rules which we discussed in Section 3:2:2. Airlines attempted to grow where they could, but ownership and control issues meant that such organic growth was limited to the domestic markets of the countries in which they were based, and largely to international routes to and from these countries. Merger and takeover activity certainly did occur, but purely with national boundaries. Still, very few examples exist in the airline industry of true cross-border merger and takeover activity.

The United States market was the one where growth and consolidation of the industry was able to proceed furthest, due to the size of the market and the permissive attitude towards mergers and takeovers adopted by successive administrations in Washington. By the middle 1990s, the industry had consolidated to the point where it was overwhelmingly dominated by six mega-carriers – American, United, Delta, Northwest, USAirways and Continental.

The US experience does not lead to a confident view that consolidation is the way to financial success for the world’s “Differentiation” airlines. During the 1990s, each of the Big Six became a hotbed of militant trade unionism, with unions finding fertile ground on which to work amongst labour groups who appeared to feel isolated and threatened. Freed of the fear of a strong competitive response by the fact that each of the big airlines held strong, hub-based, geographical monopolies, each airline progressively gave way to demands for large increases in wages and salaries. The result was that by the end of the decade, wages and salaries had risen to unsustainable levels. This left the airlines extremely vulnerable to the business downturn which then began to affect them. Once it did, the airlines showed themselves slow to respond, their sheer size leading to bureaucracy and inertia.

Outside of the United States, the quest for greater size has been just as strong but has been incapable of fulfilment. One attempt was made in 2000 to grow by a policy of cross-border takeover, when British Airways proposed a takeover of the Dutch airline KLM. This, though, merely illustrated the inflexibility inherent in the anachronistic regulatory system, because the proposal had to be abandoned in the face of threats (from the United States in particular) that KLM would have to forfeit its international traffic rights if it became British controlled. KLM did eventually get
together Air France, but with a deal where a special structure had to be adopted which in fact left the arrangement well short of a true merger.

As airlines sought the benefits of size through the 1990s and found that they were unable to obtain them through the “normal” processes of organic growth and merger and takeover, they progressively fell back on another expedient, that of alliances.

4:2:7 Airline Alliances

Alliance relationships now have a long, and chequered, history in the industry.

Throughout the history of commercial air transport, carriers have often preferred the comfort of co-operative rather than competitive relationships, but the modern alliance movement can be dated to 1993. Then, KLM and Northwest Airlines announced their wish to set up a strategic partnership. They were able to move ahead once the United States government gave them immunity from the US Anti-Trust laws, which it did following the signing of an “Open Skies” agreement between the US and Netherlands government, a development which we have discussed in Section 3:2:2.

The KLM/Northwest move was followed in 1995 by Lufthansa and United Airlines proposing what has become the Star Alliance. Again, anti-trust immunity was available once the German government had agreed to a US-style Open Skies Agreement. The Star Alliance grew rapidly in terms of the number of members it had, with it currently consisting of 19 member airlines.

A year later, the formation of the OneWorld alliance by British Airways, American Airlines and Cathay Pacific was announced. Although OneWorld has certainly developed since then, its activities have been hampered by the fact that American and British Airways do not have anti-trust immunity due to a long-running and bitter dispute about aviation policy between the US and British governments. This in turn means that co-operative discussions with OneWorld have always had to stop short of subjects of commercial intimacy such as fares and schedules co-ordination.

The evolution of the modern alliance scene was completed in 1999 when Air France and Delta Airlines formed the Skyteam alliance. Skyteam initially followed a different policy from Star, in that limited itself to a smaller, but, arguably, more manageable number of members. Now, though, attempts are being made to bring Continental and Northwest Airlines into the alliance, with bitter battles being fought to win what is seen as being the necessary anti-trust immunity.
It now seems that we are reaching a mature airline alliance scene consisting of three global alliances, Star, OneWorld and Skyteam. There does not seem to be room for a fourth.

There is one final element of the current alliance scene which should not be overlooked. Some airlines have not joined any of the global alliances. Virgin Atlantic and Emirates are both examples. Emirates, in particular, has taken a strong position of preferring to maintain its independence rather than become enmeshed in what the airline’s chief executive has called the straitjacket of membership of a single alliance.

Overall, it is clear that the formation and growth of alliances has been a central theme of the airline industry over the last decade. It is not hard to see why. A combination of theory and practice shows that, potentially, alliances can bring their members significant benefits to their bottom line. We will look first at these benefits, before considering the – often overwhelming – problems of alliance relationships.

Theoretical principles show us that the benefits of greater size – which airline alliances are essentially aiming to tap into – can be divided into two: *Economies of Scale*, which consist of cost reductions achieved through size, and *Economies of Scope*, which reflect the revenue benefits of co-operation, normally brought about by increased marketing muscle-power.

In investigating each of these areas in today’s aviation industry, we are immediately faced with the difficult question of “What is an alliance?” The word is used very loosely. It can mean anything from the most distant and loose of code-shares to a situation which is as near a merger as the present ownership and control rules allow. It also may, or may not, involve the partners in minority equity stakes.

Having said this, it is clear that airlines which enter into co-operative alliance relationships are seeking cost reductions as a result of doing so. They may engage in joint purchasing activity (though, as we shall see shortly, this is often easier said than done). A common expedient is co-operation in ground handling. If alliance partners can negotiate together, this may increase their bargaining power with the often-intransigent suppliers of airport services. Sometimes, airlines have attempted to save money by an agreement to give up being self-handling at out-stations, leaving such activity to their alliance partners. In turn, they will handle the partners at their own home base. Finally, sometimes, airlines will agree to save money by combining their sales teams, although history says that such agreements are normally only of short duration. They usually fail as soon as one of the partners finds that its revenue is falling as a result of the fact that it is no longer represented by a sales force solely motivated to promote its services.
Each of these possible areas has the potential to be important, but they are often overshadowed by the cost advantages of Code-Sharing.

Code-sharing activity between airlines can be divided into two types: that designed to cement traffic feed, and that which, however it is presented, is actually meant to reduce the intensity of competition on a route.

Code-sharing to control feed is, mostly, a legitimate activity from the consumer viewpoint. Two or more airlines may agree to share their codes, so that their connections will appear as on-line in the GDS displays. Ideally, they will then co-ordinate their activities to provide, as far as possible, genuinely seamless connections for each others’ passengers. All airlines will then benefit. In particular, long-haul airlines will gain feed from short-haul markets. It may not be possible for them to fly these short-haul routes themselves, because of ownership and control rules. Even if they can, it will often make more sense to rely on a specialist short-haul airline, with a more appropriate cost structure, to do so.

Code-sharing to reduce the intensity of competition is, inevitably, much more controversial, carrying, as it does, connotations of collusion between supposed market competitors.

Such activity has a long history in the airline industry. Prior to the development of Code-Sharing in the late 1980s, airlines commonly formed “Pooling Agreements” whereby all the revenue on a route was put into a single pot and divided up at the end of each year according to a pre-agreed formula. Modern Code-Sharing agreements, in their extreme form, are little different. All the flights on a route carry the codes of both the “competitors” and are jointly marketed by both the airlines.

It is certainly possible to argue that such arrangements bring benefits to the consumer. The airlines are able to engage in co-operative rather than competitive scheduling, giving the passenger a better spread of flights throughout the day. Also, larger aircraft may be employed, giving lower seat-mile costs and the promise of lower fares. Nonetheless, these benefits must be offset against the lower intensity of competition on a route. Generally, the consumer interest is best safeguarded by competition, rather than collusion. We will return to this point shortly.

Economies-of-Scope may deliver further bottom-line benefits of airline alliance activity. For example, a group of airlines in an alliance may co-operate in marketing by offering corporate customers deals whereby if the customer will offer loyalty to the alliance, even more attractive discounts will be available. It is believed that the Star Alliance has been active in this area. Unfortunately, securing agreements amongst the alliance members may prove very difficult because of the fact that there will still be many cases where they are competing with one another. Such activity may even
turn out to be of doubtful legality, at least within the European Union. It may be challenged as an abuse of a dominant position within the terms of the competition rules of the EU.

The question of alliance co-operation strengthening airline Frequent Flyer Programmes is a more telling one. Indeed, it can be suggested that in many senses this is the glue which has held the alliances together through all the difficulties that they have experienced – to be discussed shortly.

When an airline joins an alliance, it normally agrees to offer the benefits of its FFP to the programme members of all the other carriers. Thus, for example, if someone has a Gold Card issued by one of the other airlines, the new member airline will allow them to use its airport lounges. Reciprocal benefits will also be on offer to its own members. Even more importantly, alliances are able to offer the benefit of “Earn-and-Burn” rights. These mean that someone flying on any of the airlines in an alliance can earn miles in the FFP of which they are a member. They can also use these miles to obtain free flights on any alliance airline.

There is no doubt that “Earn-and-Burn” is a very significant marketing advantage. It is certainly a powerful argument in favour of joining an alliance, and it is the aspect of alliances which independent airlines outside of them find hard to deal with.

Despite the undoubted benefits that alliances have brought to those airlines that have joined them, one’s sense of unease remains. We are now nearly ten years into an alliance-dominated industry, yet only a relatively low proportion of the gains which were hoped for in the early, optimistic years have actually materialised. At the same time, problems have appeared which are likely to put a permanent damper on the enthusiasm for alliances, and which many mean that they end up constituting merely a transient phase in the industry’s development.

In understanding why this should be so, it should first of all be emphasised that strategic alliances are, fundamentally a difficult form of business organisation, because nobody is in overall charge. There is a constant risk that an alliance will end up using a so-called “Lowest Common Denominator” form of decision-making. This means that relatively unimportant decisions are given a disproportionate amount of time, because everyone can agree on them, whilst difficult, but vitally necessary decisions are put off, because they involve concession and compromise. Also, there is a great deal of evidence – the airline industry supports this point well, as we shall see shortly – that the more members an alliance has, the more intractable are the problems which will arise. The number of problems tends to increase exponentially with the number of members, rather than just arithmetically.
With airline alliances, perhaps the most fundamental criticism to be made of them is that they illustrate a mindset which has bedevilled the commercial airline industry almost since its inception. When faced with a tough competitor, it has nearly always been the airlines’ instinct to form collusive, rather than competitive, relationships. The enthusiasm shown by airlines for so-called “Tariff Co-ordination” within IATA (when this term was largely just a euphemism for price fixing) was an illustration of this, as was the widespread use of Pooling Agreements referred to earlier in this section.

Such enthusiasm would have been understandable had it been successful in solving the perennial problem amongst “Differentiator” airlines of inadequate levels of profitability. There is no evidence at all that it did. The reason is all too clear. Without the challenge of strong competition, airlines do not work sufficiently hard to control their costs, particularly their labour costs. They therefore quickly eat up all the guaranteed revenues which collusive behaviour gives them, leading to calls for a further diminution of competition.

It is instructive in this regard to look at two air transport markets where, historically, levels of profitability have generally been better than amongst the “Differentiator” airlines. These are the markets of charter airlines in Europe and the “Cost Leader” sector we analysed in Section 4:2:6. In both cases, these sectors have been characterised by an almost complete absence of collusive behaviour. In both cases, too, profitability has been stronger, and far less cyclical, than amongst “Differentiator” airlines. This is because airlines within these sectors have always known that cost control and cost management was a core business function, and failure to address it would be likely to result in bankruptcy. The result has been that their wage and salary rates have generally been more reasonable, and their labour productivity far higher, than has been the case amongst “Differentiator” airlines.

Overall, one is led to a cynical, but inevitable conclusion: the much vaunted cost savings that airlines are thought likely to experience as a result of alliance membership will turn out to be illusory. For all the cost savings which are achieved, there will also be cost increases as a result of the very substantial costs of the bureaucracy associated with running the alliances. Also, alliances will be the cause of a leveraging up of labour costs amongst their members.

It is true that in recent years labour cost pressures in the industry have abated, due to the disastrous state of airline finances and the fears of redundancy and job losses which this has engendered. However, there were clear signs of this leveraging effect before the crisis struck, with high salary increases for pilots at United Airlines being followed by labour
unrest at Air Canada and Lufthansa, both Star Alliance members alongside United. It may soon come back if the present signs of a long overdue recovery continue. Of course, advertising messages may not help. The Star Alliance in particular has put out large amounts of advertising emphasising the way in which passengers should view its airlines as a single entity, working together as one to improve the passenger experience. The more it does so, the more it invites the riposte from the unions within each member airline that wages and salaries should be comparable across the alliance. Naturally, this will lead to a leveraging up, rather than a leveraging down, of labour costs.

The other problem of airline alliances is a particularly pressing one at the moment. There are too many differences in financial performance and product standards amongst the alliance members. Again, the Star Alliance illustrates this problem in its starkest form. Amongst the Star Alliance carriers is Lufthansa, a carrier with high product standards and considerable financial strength. At the opposite end of the spectrum is United Airlines. United was in Chapter 11 bankruptcy for over three years, only emerging from it in the spring of 2006. Its balance sheet is still in very poor shape. How can United finance the investment which will ensure that it at least closes the gap between its product standards and those of Lufthansa? Also, how can the Star Alliance carriers generally engage in strategic discussions about developing their long-term co-operation, when they must all know the possibility exists that United may not survive? For United itself, inevitably the priority will have to be the raising of cash in the short term to meet obligations and stave off liquidation, rather than planning for the strategic strengthening of co-operation within Star. The Brazilian carrier Varig has been another Star airline which has had to deal with severe financial problems – indeed, at the time of writing it appears unlikely to be able to stay in business.

If all this sounds overly negative, it should be borne in mind that alliance relationships can be successful ones in the aviation industry. For this to happen, though, the number of alliance partners must be kept small and manageable. There must be a powerful enemy, strong enough to ensure that the alliance members have to overcome their mutual animosities and stay together. Each alliance member must know that they cannot take on the enemy alone.

In the airline industry, Airbus illustrates this point well. Since 2001, Airbus has been constituted as a fully-integrated business, but for the first thirty years of its life it was a strategic alliance of German, French, Spanish and British aerospace interests. Harmony did not always characterise relationships within the consortium, but its members always knew that they
had to stick together, because no individual firm could take on the common enemy – Boeing – on their own and hope to win.

The world of GDSs also shows this “common enemy” principle. Both Galileo and Amadeus were formed in the late 1980s by different consortia of European airlines, and neither had an easy birth. The two consortia did, though, stay intact through the 1990s, because they needed to do so. In the background was the SABRE GDS, then wholly owned by American Airlines. It was no secret that American had aggressive plans to move SABRE into a globally-dominant position, and that they had such a head start that no GDS owned just by one other airline could prevent them from doing so. The Galileo and Amadeus consortia therefore had to stay together, in order to thwart American’s plans. Now, with airlines mostly having sold off their GDS shareholdings, it is instructive that some of the most impressive examples of successful airline alliance co-operation are coming with the strong position being taken by each of the alliances in their attempts to secure reductions in GDS booking fees.

No such conditions of an overwhelming common enemy exist to underpin the difficult world of airline alliances when they are dealing with the fundamental question of where they should compete and where they should co-operate with each other. This writer’s experience is that whatever they may say in public, airlines generally regard their so-called alliance ‘partners’ as actually being amongst their most significant competitors.

The likely way forward for the alliances is that they will continue for the time being, bringing to their members some, but far from all, of the net benefits which were hoped for by their founders. Eventually, though, the restrictions on cross-border ownership of airlines – the driving force behind the formation of airline alliances – will be eased and may eventually disappear. When they are, alliances will become largely a thing of the past. They will be replaced by global airlines.

Whether this will solve the airline industry’s seemingly perennial financial problems must be a matter for conjecture. As we have seen, there has already been one market, the US domestic market, where consolidation into a small number of mega-airlines has been permitted. One of the arguments used by regulators for allowing this to happen was that it would lead to stability through improved airline profitability. The reverse has actually happened, with rising labour costs amongst the de-motivated workforces of large, amorphous and remote carriers a primary reason. There is no reason to think that true global airlines would not go the same way. Nonetheless, the movement for consolidation is likely to prove unstoppable. If it is, it will be interesting to see if the existing alliances turn out to be the basis of any global airlines that emerge. It is possible that
new groupings will come through, perhaps driven by the animosities which have arisen within the existing alliances.

4:3 “Differentiation” Airlines – The Future

4:3:1 The Concept of the “Legacy Airline”

In Section 4:2:8, we looked at the business model employed by the world’s “Differentiation” airlines. We saw that, during the second half of the 1990s, whilst profitability was still inadequate, these airlines were generally doing as well as they had ever done. Good returns were being earned by the industry’s traditionally stronger airlines such as American, Delta and British Airways, whilst even some of the weaker players (such as the Belgian carrier Sabena) moved into the black after years of losses.

Only a few short years later, the picture could not have been more different. The losses amongst the once–strong airlines of the USA were staggering, whilst in Europe airline profitability was generally weak. Some airlines were unable to survive, notably so Swissair and the aforementioned Sabena. Only in south east Asia did the traditional business model still seem to be working well, for such carriers as Singapore Airlines and Cathay Pacific. They were being joined by some of the carriers of mainland China where strong traffic growth was assisting them in joining the small elite of Differentiation airlines which were still achieving profits. Then, the SARS epidemic interrupted even this favourable trend.

In looking for any explanation for this rapid and catastrophic turnaround in airline financial fortunes, the managements of the airlines concerned would no doubt have liked us to look to factors wholly outside their control.

To some extent, we would have been right to do so. The terrorist attacks on New York of September 11 2001 dented the confidence of travellers, notably US travellers. This confidence took a long time to return. The subsequent “War on Terrorism” and the allied attack on Iraq worsened the problems of depressed demand, as passengers feared reprisal attacks on civil aviation. In turn, the need for increased security checks at airports added to the hassles associated with air travel, making the discretionary traveller who did not have to make a particular trip much more likely to stay at home. For the business traveller who chose not to fly, they could, of course, continue their business much more easily than before because of advances in electronic forms of communication.

External factors associated with wars and terrorism were a part, but by no means the whole, explanation for the woes of the Differentiation airlines
which they experienced between 2001 and 2005. These airlines would also want us to use as an excuse the economic slowdown which began in the United States in 2000, and subsequently spread to other markets.

Airlines are never likely to find things as easy in a recession as they do in prosperous times, but we should be wary of giving too much credence to arguments that the economic slowdown is an “external” factor about which airlines can do nothing. During the boom years of the 1990s, many airlines pursued aggressive expansion programmes, despite the fact that the evidence of history suggested that the world economic boom then in progress was overdue for a correction. Even more unforgivably, they often based their expansion plans on a concentration on “Premium Traffic” – that in First and Business Class cabins. It is schoolboy economics to say that this was a mistake, because all the evidence one could possibly require is there to say that this is the type of traffic most severely affected by the onset of recession. British Airways is but one airline of many at which the criticism can be levelled that its strategy involved an extremely risky concentration on the Premium end of the market.

Of course, as we have seen, at the same time as Differentiation airlines struggled in a recession-hit market, many Cost Leader airlines saw little effect on their growth and profitability. This is because their business model showed itself to be far more resilient in the face of the ups and downs of the Trade Cycle.

Aside from “Terrorism” and “Trade Cycle” issues, Differentiation airlines were affected by fundamental changes in customer needs and market segmentation. The rapid rise in the importance of the “Independent” business traveller, who regarded the price of the ticket as being much more important than their corporate counterparts, was one factor in this, depressing yields significantly. The increase in the amount of business travel sold on the basis of corporate dealing (see Section 2:2:4) had a similar effect. It is not convincing, though, for airlines to argue that they were the innocent victims of these trends. It is certainly possible to argue that successful carriers are always likely to be those which anticipate change and are ready when it occurs. Unsuccessful carriers are often those which wait for change to happen and then make a belated response to it. In many ways, the problems endured by many traditional Differentiation airlines illustrated exactly the latter failing.
Table 4.2  Staff Costs 1999(Average Annual Remuneration, USD)

<table>
<thead>
<tr>
<th>Airline</th>
<th>Pilots &amp; Co-pilots</th>
<th>Cabin Attendants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Air Portugal</td>
<td>$144,570</td>
<td>$44,215</td>
</tr>
<tr>
<td>2. British Airways</td>
<td>$121,153</td>
<td>$30,815</td>
</tr>
<tr>
<td>3. British Midland</td>
<td>$ 94,995</td>
<td>$28,721</td>
</tr>
<tr>
<td>4. Iberia</td>
<td>$188,091</td>
<td>$59,340</td>
</tr>
<tr>
<td>5. Lufthansa</td>
<td>$141,646</td>
<td>$50,017</td>
</tr>
<tr>
<td>6. SAS</td>
<td>$129,445</td>
<td>$58,441</td>
</tr>
<tr>
<td>7. Virgin Atlantic</td>
<td>$ 85,048</td>
<td>$18,810</td>
</tr>
</tbody>
</table>

Source: ICAO.

Other criticisms of these airlines are in a sense even more damning. Table 4.2 presents data giving average salaries for selected work groups at a number of European airlines at the height of the boom in the late 1990s. By any standards, some of the numbers are excessive, and reflect the fact that, as we have seen, airlines had little incentive to control their costs when regulatory protection meant that they had nothing to fear from the potential threat of lower cost new entrants. Nor could such high rewards be said to reflect what people might be entitled to expect from working for highly profitable and successful businesses.

Of course, high wages and salaries need not indicate high unit costs, if they are offset by extremely high productivity. Southwest Airlines has always prided itself on not being a sweatshop. All the work groups at Southwest are rewarded at market rates, or at levels which are even somewhat above the average. Its remarkable ability to maintain low unit costs, even now when it is a very large and mature airline, reflects the fact that its labour productivity is very high.

The same conclusion cannot be reached for most traditional airlines. For example, the rules governing pilots’ hours as set by the various regulatory bodies are complex, but in summary allow pilots to work a total of 900 duty hours in a year. Many European airlines had agreements with their pilots which require them to work only two-thirds or even a half of the permitted maximum. Not surprisingly, Ryanair has made it a condition of the jobs offered to pilots that they will be rewarded at market rates, but that they should expect to work the full number of hours which the regulators allow.

Besides having a cost base which was no longer sustainable in difficult, changing, market conditions, there are two other aspects of the
traditional business model of Differentiation which rendered it under threat, especially in short-haul markets.

We have already referred to the way in which Cost Leader airlines concentrate on point-to-point traffic, avoiding the extra costs and revenue dilution associated with connections and transfers. The whole of the traditional business model of Differentiation was based on transfer traffic and hubbing. Fares were kept extremely high for point-to-point passengers who had few choices available to them. Much lower prices were offered to connecting passengers to encourage them to use the airline’s hub, rather than the connecting possibilities offered by other carriers.

There is an economic defence to be offered for such a pricing policy. Hubbing passengers, even though they are low-yielding, contribute to the spreading of overheads and allow for frequencies to be increased over a wider route network. They also permit larger aircraft to be used, which may allow the passenger to benefit from the lower seat-kilometre costs associated with bigger planes. The model is, though, entirely dependent on high fares being paid by point-to-point passengers if overall costs are to be covered. In that sense, it can be argued that it is based on cross-subsidy from point-to-point to connecting passengers.

In recent years, this aspect of the business model of traditional airlines has ceased to work. As we have seen, the Cost Leader players specialise exclusively in point-to-point traffic, and their fares do not contain this element of cross-subsidy. They have taken away a significant proportion of the point-to-point traffic of rival airlines, meaning that, overall, the business model for short-haul routes is no longer offering the prospect of adequate profitability.

A final set of criticisms can be made of airline Revenue Management policies. Pricing and Revenue Management is the subject of Chapter 6 of the book, but it can be stated that a sound Revenue Management policy will have many components. One aspect will be to vary prices according to people’s willingness and ability to pay.

Traditional airlines took such a policy too far. On short-haul routes prices were kept extremely high for people who needed a flexible ticket. Much lower fares were available, but on a strictly controlled basis whereby those using them had to comply with tight conditions regarding (sometimes) an advanced booking requirement, length-of-stay rules and restrictions on cancellation and re-booking. The result was that those using flexible tickets paid prices which to the airlines charging them were extremely high yielding.

The fact that they were was long regarded by Revenue Management professionals as a triumph. People who had to travel, often at short notice were paying prices which reflected their very low price elasticity.
Unfortunately, it is now clear that these policies were having another, less desirable effect. They were responsible for a strong feeling of resentment against the airlines whose pricing policies were actually reflecting the fact that those using high priced tickets had no choice. All traditional airlines were using the same pricing policy, and regulation was preventing the entry of new airlines into the market.

Now, the situation is very different, with the explosion of entry of Cost Leader airlines. In turn, this entry has shown up what could be described as the “water behind the dam” effect of airline Revenue Management policies. Those who paid very high fares before were not “willing” to pay them as the jargon of Revenue Management would suggest – rather they were “forced” to pay them by the lack of choice. Once a choice became available, many have taken a particular pleasure in voting with their feet and transferring to Cost Leader airlines, partly to punish those whom they believed had exploited them. Overall, one can say that the attitude of consumers to high air fares changed for all time. Cheap point-to-point fares became regarded as the norm, and high prices as exceptional and unjustified.

Overall, we are forced to a depressing conclusion about the business model of Differentiation in the airline industry. Only a short time ago, this model was earning reasonable returns for the better-managed airlines. Then, there was a long period when it failed to do so. Wars and terrorism fears depressed demand, and may do so again, at any time. The business model was shown to be incompatible with the ups and downs of the Trade Cycle, with airlines hoping against hope for an early resumption of strong economic growth to rescue them. Market segmentation and customer needs changed, lowering yields and giving opportunity to rapidly developing competitors from the Cost Leader sector. The business model of the airlines was also shown to be built on the sand, being based on the charging of unacceptably high prices to supposedly “captive” business travellers, and on cross-subsidy from point-to-point to connecting passengers.

Of course, at the time of writing, (summer 2006), things might be held to be different. 2005 and the first half of 2006 have seen signs of improvements in the finances of even some of the world’s most troubled airlines, despite the problem of continuing high oil prices. We may, though, be in a fool’s paradise, with financial improvements being driven largely by the buoyancy of demand, fuelled in turn by strong growth in the world economy. This boost will disappear when growth slows again. It is interesting, too, that the airlines have responded to the short term improvements in financial performance by ordering new aircraft in staggering numbers. Both Boeing and Airbus had record years in 2005 in
terms of the number or orders they took for new aircraft. Will airlines never learn?

Such a litany of problems would be very serious indeed for carriers trying to navigate their way through challenging times with fully competitive cost structures. Unfortunately, long-established airlines have often had a high cost legacy built up during times of state-ownership and the absence of price competition or, in the case of US airlines in particular, during a time of strong union militancy in a then-buoyant market.

In recent years, a new term has come into common usage to describe many of these carriers – “Legacy Airlines”. It is an appropriate one. They have attempted to navigate extremely difficult waters with a set of problems left over from a time when circumstances in the industry were very different. They have had competition from newer airlines that have had the priceless advantage of setting out in recent competitive market conditions. They therefore had no legacy from the past to deal with.

Given this litany of problems, it is not at all surprising that recent years have seen a great deal of discussion of the strategic options open to the Legacy sector.

4:3:2 “Legacy Airlines” – Strategic Options

For these airlines, it should be emphasised that their situation is by no means hopeless. They carry with them some very valuable strengths today, and have worthwhile opportunities which will open up for them in the future. For example, the very fact that they are long-established means that they have Grandfather Rights on airport slots which often stretch back many years. They will retain these rights into the future, unless the industry radically changes the methods used for slot allocation, something which, at the time of writing, appears unlikely. Also, and despite the criticisms of hubbing made in the previous section, their hubs do give them opportunities to gather in traffic from a wide geographical area, and provide a worthwhile fortress against new entrants. As we have seen, their Frequent Flyer Programmes are valuable, and pose a difficult competitive issue for smaller newcomers. Also, despite the criticisms made in Section 4:2:6 about airline alliances, one has to concede that to some degree alliance membership should be seen as a strength, particularly when it comes to negotiating with ‘common enemy’ outside suppliers.

Perhaps of greatest value to these airlines is that they still have a defendable position in long-haul markets. As we have seen, it is much harder for Cost Leader approaches to succeed on long-haul routes, because of the difficulties such airlines have in establishing and sustaining a substantial cost advantage.
Finally, the very fact that “Legacy” airlines are long-established allows them to make the branding claim that they are “proven”. A carrier with an unblemished safety record stretching back for many years is likely to be able to persuade the nervous traveller to choose them rather than a new entrant, whose safety promise must be taken on trust. Unfortunately, for British and American airlines, the fact that they may have a proven safety record may not be enough to stave off the perception that they are a possible target for terrorist attack, following on from the Second Gulf War of 2003 and the so-called ‘War on Terror’.

Despite these strengths, the Legacy airlines have had to change their strategies. Indeed, those that have not done so have simply gone out of business, or have become dependent on state handouts and protection. The question is, what strategic options have been open to them? Fortunately, there have been a number. No single option has provided all the answers. Carriers have had to select the best parts of each one in order to define an overall strategy.

A first option might be described as a “Retreat to Core” strategy. As we have seen, the Legacy carriers still have a defendable position in long-haul markets. Also, despite the radical nature of the developments which have taken place on short-haul, they have not affected every passenger. There is still a hard core of business people who will pay high prices for a flexible ticket and a seat in a comfortable Business Class, even on short journeys. Has it been possible to retreat to this core of high-yielding and hopefully profitable business? Certainly, at the present time all the Major US airlines are trying to increase the emphasis which they are placing on long-haul international services, while shrinking their involvement in the American domestic market, where competition from Low Cost Carriers is at its most intense.

Strategies of retrenchment are notoriously difficult to implement in the airline industry. They require, to begin with, a complete re-planning of the fleet around smaller aircraft. Those high yielding passengers who constitute the supposed core will normally be business travellers, who will in turn be extremely frequency-sensitive. Airlines will also need to maintain frequency to ensure that there are sufficient numbers of connecting passengers feeding into their long-haul services. Fortunately, there are now suitable aircraft available. The smaller versions of the B737 and Airbus A320 families are well-proven, if less than optimal, aircraft. Embraer is now introducing its 170 and 190 families of new aircraft with around 100 seats.

Although these aircraft have good operating economics, inevitably their seat-kilometre costs are quite high, especially given the generous salaries normally paid to pilots by Legacy carriers. These salaries are, of
course, especially punitive when spread over only the hundred seats or so of a small aircraft.

This aspect of “Retreat to Core” strategy is one aspect of a more general problem. Such a retreat involves cutting back on the scale of an airline’s activity. The reduction in revenue will be immediate. Far more problematic will be the carrier’s ability to reduce overhead costs at the same rate, or, hopefully, faster, than revenue declines. Achieving this in the airline industry is notoriously difficult. A far more likely situation is that the decline in overhead will be less than the decline in revenue. Each passenger who remains will then, through the fares that they pay, have to cover a greater proportion of overhead if overall profitability is to be achieved. Given the long term trend in the industry for yields to decline rather than rise, it is unlikely that they will.

The other major problem of “Retreat to Core” strategies is that they can leave market opportunities open to competitors. The situation in the UK aviation industry illustrates this problem well. Many short-haul destinations have been served from both London’s Heathrow and Gatwick Airports. Generally, profitability has been much better on the routes from Heathrow. If an airline is making money by serving a destination from Heathrow, whilst incurring losses on the equivalent route from Gatwick, the solution appears to be obvious. By cutting out the Gatwick service, the profitable core can be identified and overall profitability achieved. Unfortunately, in practice, the situation may not be so simple. Giving up a route may involve the relinquishing of airport slots which under the “Grandfather Rights” rules described in Section 3:2:6, can then be awarded to another airline on an “in perpetuity” basis. This airline may then use the slot to sharpen its attack on the rival which gave it up in the first place. This may involve beginning service on the specific route abandoned by the first airline. If the challenger has lower costs and more attractive fares than its competition, traffic may be attracted from the “core” route, turning it from profit into loss-making.

The second strategic option is a very clear one, and has been dealt with in Section 4:2:4. If “Legacy” airlines find that their position in short-haul markets is being undermined by “Cost Leader” players, it seems the most obvious of initiatives for them to fight back by setting up Cost Leader subsidiaries of their own. The jury is still out on the question as to whether this is a sound strategy or not. So far, the results produced by it have been, at best, mixed. Those airlines which have recently decided to use it will no doubt argue that lessons have been learned, and that we should now be talking about “second generation” Cost Leader subsidiaries which will achieve much better results.
completed, both South African Airways and Iberia announced that they were intending to set up new Cost Leader subsidiaries, so the area is certainly still an active one.

It is interesting to note that some airlines have examined and rejected the idea of a Cost Leader subsidiary. Aer Lingus has never set up such an airline, despite being the first European airline to face competition from a Cost Leader player (Ryanair is based in Dublin), and to face it in a particularly severe form. As we have seen, British Airways set up a Cost Leader subsidiary called Go, but sold it in 2001. If the public statements of the present BA Chief Executive are to be believed, they have no plans to re-enter the sector.

All Legacy airlines, whether they have set up a Cost Leader subsidiary or not, have had to follow the third strategic option. They have had to do all they could to reduce their cost base. If they can reduce the often enormous disparity between their costs and those of the newer Cost Leader airlines, they are then in a position to lower their fares themselves. They may also be able to regain some of the passengers who may be unhappy at the sacrifices the Cost Leaders require them to make to gain access to their cheap prices.

Some of these cost reductions have been achieved relatively painlessly. All airlines have undoubtedly leant on their suppliers and demanded concessions from them. In a recession-hit industry, these suppliers have had little choice but to agree, especially if airlines pursue tough policies to reduce the number of their suppliers so that they are able to exercise the maximum amount of buying power over them. Commission costs and GDS booking fees have come down everywhere as airlines have relied on such initiatives as electronic ticketing and selling over the Internet. A growing self-service culture has been encouraged through useful developments as self-service or, more recently, on-line check-in. Finally, some successful attempts have been made to cut out some of the complexities which Legacy airlines have traditionally built into their business model. This has in turn allowed for lower costs as a result of a reduction in overhead expenses.

Important though such initiatives have been, they do not address the key question. As always, has been those airlines that have successfully dealt with the perennial Legacy airline problem of labour costs that are now the best placed to face what is bound to be very rough weather in the future.

Labour costs are vital to Legacy airlines because they are the biggest single input cost item for them. Commonly, 30% or more of their costs are made up by wages, salaries and benefits. Addressing labour costs therefore has the greatest single impact on unit costs. Unfortunately, in
doing so, airlines have been faced with the fact that their unions are generally in a very powerful bargaining position. The list of work groups who can paralyse an airline through strike action is a very long one. As service businesses, carriers have no opportunity to build up inventory with customers in advance of a strike. Once it begins, the effect of a strike on cash flow will be immediate. In the case of one work group – pilots – airlines have to deal with people who are generally articulate and intelligent and with a long record of militancy at many carriers. Finally, in the view of this writer at least, airlines have worsened what would in any case be a difficult labour relations environment by their continuing belief that big is better. Too often, people working in large airlines feel isolated and threatened, providing fertile ground for trade union militancy.

In some cases, carriers have resorted to extreme measures to bring down their labour costs. The US Chapter 11 bankruptcy code allows a firm to receive, for a period of time, court protection from its creditors. Several airlines have used time in Chapter 11 to radically change their labour contracts, emerging from bankruptcy with a much lower cost base. USAirways did this in 2002/3. Air Canada used the Canadian equivalent at same time. United Airlines and Delta have done so subsequently. Others have used the possibility of bankruptcy as a threat. American Airlines in March 2003 obtained significant concessions from its normally militant unions by suggesting that a bankruptcy filing would take place if these concessions were not granted. The unions knew, of course, that they would be taken anyway if American had gone in Chapter 11.

More generally, it often proves possible for airlines to lower labour costs in a time of crisis. The threat of bankruptcy, or at least of large job losses, will usually be enough to focus minds. The problem, of course, is that demands will be made for the old conditions of service to be re-instated once happier times return. In the meantime, customer service standards will slip, if the workforce becomes punch-drunk and demoralised.

A further possibility for addressing labour cost issues is to make a proportion of the rewards available depend on company performance through stock options and profit-sharing schemes. Such methods have been used by some of the new entrant Cost Leader airlines, where profits have been good and share prices rising. They are of no relevance, though, to Legacy airlines where share prices have fallen to very low levels and profits are non-existent. In any case, the whole question of employee shareholdings has been discredited by the experience of United, where for a number of years the employees actually owned a majority of the company’s shares. This did not turn out to be a recipe for harmonious labour relations – much the reverse. The experiment was finally abandoned in March 2003.
Overall, we can say that if there was an easy, miracle solution to the problem of labour costs and labour productivity at the Legacy airlines, it would have been found by now. Moving forward on the labour cost front has, though, been vitally important, and inaction has not been an option. Further progress will depend on the correct policies being pursued in a wide range of areas. This author believes that the most important factor will be inspiring, sympathetic and considerate leadership, by a leadership team which convincingly demonstrates that it does not have its own snout in the trough whilst asking others to make sacrifices.

If costs can continue to be brought down, and the reductions maintained on a permanent basis, exciting new opportunities will appear. We have looked in Section 4:2:3 at the successes of Cost Leader airlines, but it is clear that from the consumer viewpoint, flying with these airlines does have its drawbacks. People may have to use an inconvenient airport, accept a “no frills” on-board product or be denied a seat-selection service. Most importantly, some of the Cost Leader airlines appear to be taking a gamble on questions of customer service. If things go according to plan – and they usually do – passengers benefit from remarkably cheap fares. If things go wrong, though, the passenger experience may be very different. The European press and media regularly carry horror stories about the problems experienced by passengers whose flight is badly delayed or whose bags are lost. Once such a severe service failure has been experienced, is a passenger’s view of Cost Leader airlines changed for all time, and will they become willing to pay more to fly on an airline which does give appropriate attention to customer service? If they do, full service airlines can be expected to benefit from the gradual build-up of a so-called “Army of the Disaffected”, of those who feel that they have been let down by the Cost Leader sector.

It would be wrong to exaggerate the importance of this trend. There will be no return to the days of extremely high airfares. Sound standards of customer service may, though, allow the Differentiation airlines to hold prices a small amount above those of the lowest pricing Cost Leaders. For those that can reduce their costs down to these levels, a return to profitability for their short-haul services may still be possible.

A strategic option which has been followed by many Differentiation airlines has been to subcontract some of their short haul feeder services to airlines with a more appropriate cost structure. As we have seen, service on thinner routes often presents traditional airlines with particular problems. Pilots unions have generally successfully made the case that pilot salaries should be higher for flying bigger aircraft. They do not usually accept the corollary that if an airline introduces smaller planes, salaries should fall.
The result is that carriers often end up flying regional jets on the basis of high pilot salaries, making profitability on thin routes impossible.

The answer to this problem is to ensure that the thinner routes are flown by regional airlines with better cost structure, using Code-Sharing and franchising relationships. Though such expedients raise questions about brand integrity, the policy has generally turned out to be a sound one. The large airline gains the benefit of feed onto its long-haul routes without the costs of trying to do the job itself. The smaller carrier also benefits through such aspects as membership of the major carrier’s Frequent Flyer Programme.

Despite the usefulness of franchising, there has been a limit on the extent to which it can be employed. Strong resistance has been encountered from pilots’ unions, who have interpreted it – often correctly – as being a device to reduce the number of highly paid pilot jobs, as regional subsidiaries or franchise partners take over an increasing proportion of short-haul flying. The result has been their insistence on “Scope Clauses” which limit the number of small regional jets that can be flown to a fixed, small, percentage of the aircraft in use by the mainline airline. The disastrous financial state of many airlines in recent years has given opportunities for these clauses to be renegotiated along more flexible lines.

A last strategic option open to threatened Legacy airlines might be described as “Jugular Marketing”. If the position of a long-established airline comes under attack from new entrants, it may respond aggressively. Fares may be cut to the levels of the newcomers, or even below them. Capacity may also be added so that there is a glut of seats in the market. Such a policy will be designed to drive the new entrants out of the market, and also to send a clear message to others to keep away. Lufthansa’s policies in Germany towards Low Cost Carriers do, at the time of writing, seem to reflect exactly these principles.

Such tactics now have to be employed with caution. It will depend on the particular legal jurisdiction under which the airline is operating, but they may well be interpreted by the courts as representing an “Abuse of a Dominant Position”. None-the-less, the dividing line between what is an abuse and what is a legitimate (and, from the consumer viewpoint, desirable) response to a competitive challenge will always be a fine one. Established airlines cannot be expected to do nothing, nor should they be, as the ground is taken from beneath their feet.

This has been a difficult section of the book, and it will be a relief in the next one to reach happier ground. The facts, though, cannot be avoided. The undermining of the position of many once strong Differentiation airlines has been the major strategic trend in the industry over the past five
years. The best managed of these carriers certainly do have a future, but they have had to radically reform their ways of doing business.

4:4 “Focus” Strategies

4:4:1 Types of Focussing in the Airline Industry

In Section 4:2:1 we looked at the two-by-two diagram developed by Professor Michael Porter to describe different business strategies. Using the diagram, he suggests that there are two possible Focussing positions. They both involve the same principles – giving up all benefits of synergies by concentrating on one single activity. Sustainable Competitive Advantage can then be found through the expertise built up in one area. Where focussing works successfully, this expertise will be so great that the firm will be able to use it to hold off the competitive challenge of the so-called ‘Industrywide’ Differentiation players, who often will base their pursuit of Competitive Advantage on the synergies available to the multi-product firm.

In the diagram, Porter proposes that successful Focussing can come about in two ways. Some Focussing firms achieve a defendable position by adding a great deal of value, which allows them to cover high production costs and still sustain profitability. Others use their expertise to achieve very low costs.

The airline industry illustrates both of these positions.

4:4:2 “Value Added” Focussing

A very good example of “Value Added” focussing in the airline industry is that of “Integrated Carriers” such as Fedex and UPS. Both these firms are now long-established, and both have modified their basic business strategies in recent years to reflect changing market conditions. They have, though, always had a strong emphasis on a single activity – the provision of guaranteed next-day delivery services for shippers who need to send small, urgent packages.

Such a service cannot be provided cheaply. Indeed, capital investment needs are enormous. Integrators need to invest in very large fleets of freighter aircraft. They generally cannot rely on the services of existing airlines, which, on short-haul routes at least mainly provide capacity in the daytime, in passenger aircraft belly-holds. They also must construct and run costly sortation centres at their hubs, centres which are capable of dealing with millions of packages in a short two-or-three hour window in the middle of the night. Huge investment will be needed in the surface
transport vehicles which they will need in order to offer the collection and delivery part of their service. They will also be involved in heavy spending on Information Technology in order to provide the tracking and tracing options which their customers expect.

Such large capital requirements provide a formidable barrier-to-entry. It now looks likely that UPS and FedEx will be the leading players in the duopoly which has always been likely to be the mature structure of the integrated operations industry. It is possible, though, for those that make the investment to cover their costs and achieve profitability because of the uniqueness of their product and the substantial amount of value that they add. Prior to the arrival of the Integrators, the shipper of a small urgent package was required to solve most of their problems themselves. Traditional airlines were only interested in the undemanding task of moving goods on an airport-to-airport basis. Collection and delivery had to be arranged by the shipper, normally using the services of an air freight forwarder. In addition, it was rarely possible to achieve the late afternoon collection, early next morning delivery ideal because, as we have seen, combination airlines relying on belly-hold capacity had most of their freight space available in the daytime. Little was available at the dead of night, as it would need to be if true overnight delivery was to be available.

Another value-adding Focussing proposition has been tried frequently in the airline industry, but appears to offer a much poorer chance of sustainable profits. This proposition is based on the idea of focussing exclusively on meeting the needs of the business air traveller.

At first sight, the strategy appears to be a promising one. Market surveys amongst higher status business travellers show that they expect such things as high standards of seating comfort and in-flight service from the airlines they choose. Sometimes, though, an additional factor emerges. Business travellers often say that they dislike flying with those on vacation, who may be noisy and disruptive. They say that they would prefer their own airline, where their needs and status can be properly recognised.

Given such apparently fertile ground, there has been a regular supply of start-up airlines focussing purely on the market of high status business travellers. MGMGrand Air was a United States example – it ceased trading in 1995. From 1995 until it closed in 1998, Fairlines was a European equivalent, flying all First Class services from its Paris base.

In October 2005, two new, very interesting, airlines both began flying the route between JFK Airport in New York and London’s Stansted Airport. Both have been employing an ‘All Business Class’ strategy, though there have been substantial differences in the detail of the strategy that each has adopted. The first, Maxjet, has been flying a Boeing 767, with good, but not exceptional, standards of seating comfort – each aircraft
has been configured with just over 100 seats. Eos Air, in contrast, is using a single-aisle Boeing 757, but has placed only 48 seats in the aircraft. These offer truly remarkable standards of seating comfort, with each seat folding down into a flat bed, and provision for another seat to be available so that business meetings can be held during the flight.

Despite their popularity with start-up entrepreneurs, no business travel focussed airline has yet stood the test of time. This is firstly because the concept is based on a misunderstanding of the priority of need of the business traveller. Business people certainly appreciate high standards of in-flight service and the benefits in terms of status and exclusivity which having their own airline can give them. Their most important needs, though, are more mundane. They must have a high frequency of conveniently-timed flights over a broad route network. They also appreciate the personal gains available to them (using their employer’s money) of a Frequent Flyer Programme. All these needs can be better met by Differentiation airlines, exploiting the synergies available from carrying both business and leisure travellers. Indeed, one of the great problems of business traveller focussed airlines is the question of what they do with their aircraft during holiday periods and over the weekend when the business market falls away.

The second problem with the All Business Class concept is that it is as far away as can be imagined from a niche strategy designed not to provoke a damaging competitive response from stronger and more powerful rivals. Eos Air in particular is targeting well-established rivals – British Airways, Virgin Atlantic, United Airlines and American Airlines, on one of their most important and profitable routes. It is also seeking to take market share away from them in the most important market that they have – high yield passengers in the First and Business Class cabins. In doing so, it is provoking these airlines into a competitive battle that they simply cannot afford to lose. Sadly, a bloody and (for Eos) fatal confrontation looks to be a serious risk.

Of Eos and Maxjet, perhaps one can be more optimistic in the case of Maxjet, and it is possible that this airline will set a new template for a successful ‘All Business Class’ strategy. Its fares (and unit costs) are much lower than those of Eos, and it appears to be aiming at the much larger market for full economy and ‘Premium Economy’ passengers (to use Virgin Atlantic’s jargon). It may be able to find profitable uses for its aircraft on charter work during slack times for business travel. Finally, by choosing a wide-bodied rather than a narrow-bodied aircraft, they will have air cargo as a potential source of revenue, given that the airline’s concentration on business travellers and relatively small number of seats in each aircraft will mean that little belly hold space will be taken up with
passenger’s baggage. Its prospects will look particularly bright if it can find working relationships with the Low Cost Carriers which dominate short-haul flying out of London’s Stansted Airport.

Despite one’s reservations about Eos Air, there may be one possible way in which a business traveller Focus may work and that is under the umbrella of a full-service airline. In many senses, the Concorde flights of Air France and British Airways were exactly that, being focussed on the tiny “tip of the pyramid” market. Both airlines continued with them for a long period, so one must assume that a profit was made, though “profit” has a doubtful meaning when the airlines received the aircraft free of charge from their respective governments. The services, were, of course, terminated in October 2003, largely due to technical problems with the aircraft and their increasing age.

Concorde services have come to an end, but an experiment has recently been mounted by the German carrier Lufthansa which may have interesting possibilities. Both Boeing and Airbus offer corporate jet versions of their narrow-bodied aircraft, Boeing with its 737 and Airbus with the A319. In essence, because corporate jets do not need large amounts of belly-hold space to be available for passenger’s baggage, the manufacturers have used some of the belly-holds of their aircraft to install the extra fuel tanks necessary to give corporate customers the long ranges which they expect.

During 2002, Lufthansa entered into an arrangement with the Swiss-based corporate jet operator Privatair that Privatair should provide corporate jet services on three routes between Germany and the USA, with the aircraft configured with 48 all-Business Class seats. The services are branded by Lufthansa and sold through the Lufthansa marketing system. Users are given privilege and exclusivity, but have all the back-up in terms of frequency and network of Lufthansa’s “normal” services. They are also able to gain points in the Lufthansa “Miles and More” Frequent Flyer Programme. An additional selling point is that Dusseldorf Airport is used, rather than Lufthansa’s main hub at Frankfurt. This allows passengers to escape from most of the delays and security hassles that they might otherwise encounter. In any case, it would not be possible to mount the services from Frankfurt because of the slot shortages which exit there.

Since 2002, Lufthansa has continued with these services, and has expanded the number of destinations served. One must therefore assume that they are satisfied with the financial results. Also, Swiss International Airlines (now closely associated with Lufthansa), has begun similar services out of Zurich. Air France has also started a comparable co-operation with Privatair, though its All Business Class services are mainly on new routes (to oil-related destinations) that the airline has not previously served.
A final example of *Value Added* focussing in today’s airline industry marks the policies being pursued by many smaller airlines from tourism receiving countries. Airlines such as Air Mauritius and Air Seychelles could be said to be engaging in a form of “Geographical” focussing. They cannot set out to conquer the world, but they can claim to know the particular country where they are based better than anyone else. Someone on holiday choosing them might feel that their vacation was beginning sooner than would be the case on, say, British Airways or Lufthansa where the flight to their holiday destination would be just like any other.

4:4:3 “Low Cost” Focussing

The airline industry does show one good example of firms which use their Focussing expertise to achieve very low costs, rather than to add value.

Europe has a long tradition of aviation activity by “Charter” airlines. Originally, these airlines developed because of a gap in the regulatory blanket enveloping European carriers, whereby Charter carriers were given much more freedom than Scheduled airlines, providing they kept to the so-called “Inclusive Tour” principle. This meant that they could not retail seats direct to the public. Instead, they were limited to a wholesaling role, wholesaling seats to tour operators. The tour operators would then add in the accommodation and other elements to make up a packaged holiday, and undertake the retailing of these holidays. The rules were essentially introduced as a compromise which allowed the Charter sector to develop, whilst giving a measure of protection to Scheduled carriers with their supposed obligation to provide year-round on-demand services.

Today, these regulatory limitations have been completely removed (at least within the European Union) but the business model to which they gave rise persists. European charter airlines developed a way of working which saw them focus on one single activity – the wholesaling of blocks of seats to tour operators. In order to attract the business of these tour operators, they had to achieve one thing above all others – low seat-kilometre costs.

Such costs were achieved in a number of ways. The airlines used relatively large aircraft, because their customers were not seen as being frequency sensitive. Aircraft as large as the Airbus A330 became common in the fleets used by Europe’s Charter airlines. Seat pitches were kept low, commonly at only 28 or 29 inches. Aircraft utilisations were pushed to remarkably high levels of 4200 – 4300 hours per year, spreading ownership and lease-rental costs. Achieving such figures was especially challenging because the market had a clear winter off-peak period. During the summer peak, aircraft were often flown throughout the night as well as the day,
reflecting the fact that a proportion of package holiday customers were prepared to use “dead-of-night” departures providing that fares were low enough. Also, and in advance of the “Cost Leader” revolution which is now affecting them so much, Charter airlines kept with the idea that the provision of food and drink on board the aircraft need not be on a complementary basis. Instead, it was made a source of revenue.

Today, the situation facing Europe’s Charter airlines is a very challenging one. The industry has mostly consolidated into two huge, vertically-integrated firms under the leadership of the German-based TUI and CNTouristic groups. This has made life hard for smaller independents. Also, customer needs have changed radically. Many people do not now require rigid package holidays containing the three elements of airline seat, accommodation and surface transfers. They certainly will not if they have their own accommodation with a villa or a timeshare, but generally now people are more experienced and adventurous, and are often prepared to put together their own holidays using the Internet.

In many ways, the newer Cost Leader airlines are better suited to these trends than the rigid model of traditional Charter airlines, and the Charter carriers have had to respond. Some have set up their own Cost Leader subsidiaries – My TravelLite and Hapag-Lloyd Express were both examples of this, although both have now been re-integrated into their parent airlines. Almost all of them have now set up web-sites to enable at least a proportion of their capacity to be retailed direct to the public. Monarch Airlines and Excel Airways are UK-based examples of carriers which have taken this initiative. In doing so, they have one crucial advantage over the Scheduled airlines. Because competition amongst the Charter carriers has been intense for a long time, these airlines generally do have the low operating costs necessary for them to compete. If they can maintain them, the Charter airlines of Europe do have a sound future, even if their business model will have to be substantially modified.

Overall, the history of the European Charter sector illustrates very well both the advantages and disadvantages of a Focussing approach. By focussing on a single activity, the Charter carriers were able to achieve a great deal of expertise in their single area of activity – expertise which for many years allowed them to hold off the competitive challenge of the ‘Industrywide’ airlines. This was despite the latter having many synergies available to them as a result of being in different markets and offering different products under the one corporate umbrella. The Charter airlines have, though, been vulnerable once demand began to move away from the product that they had become so expert in providing.
4:4:4 “Lost-in-the-Middle”

Porter’s Competitive Advantage model has one more concept we need to consider in the context of today’s aviation industry – that of the “Lost-in-the-Middle” firm.

Porter argues that there are firms that do not fit into any of the boxes. Their costs are too high for them to pursue Cost Leadership and there is too little about them which is distinctive for true Differentiation to be achieved. They are also too broadly-based in their activities to gain the benefits of expertise through Focussing.

Sadly, the airline industry today has an almost endless list of firms to which this description can be applied. As we have seen, the structure of the industry has always been distorted by ownership and control issues, with the result that there are many more airlines in the world today than would be the case if market forces had been allowed to prevail. If ownership and control constraints are eased in the future, (which is now looking increasingly likely), many of them will not survive, especially if rules about State Aid for struggling airlines are more rigidly enforced.

4:5 Airline Business and Marketing Strategies – Common Mistakes

We have now almost completed our survey of the strategic options open to carriers in today’s airline industry.

Unfortunately, the world’s smoothest diplomat could not argue that the industry presents a picture of strategic success. Periods of severe loss-making have occurred regularly throughout the industry’s history and, as we have seen, between 2003 and 2005 these losses were at a catastrophic level for many airlines. Bankruptcy has been a common feature, whilst a large number of carriers would not have survived without substantial government handouts.

When an airline fails, it is, of course, a tragedy for those affected. A bankruptcy does, however, at least give an opportunity for lessons to be learned. The problem with the airlines is that they rarely are. Each airline failure does, of course, reflect some unique circumstances, special to a particular case. What is so depressing, though, is that the same issues, mistakes and problems seem to arise time and again. In this last section of the chapter, we review some of these common mistakes made by failed airlines.
4:5:1 Objectives

The writing of classical economists suggests that firms should be viewed as rational entities, lead by entrepreneurial managers whose objective is profit maximisation. In the airline business, such a theoretical position is often far from the true one. Airlines are set up and run for many reasons, which often make the achieving of satisfactory profits impossible. Sometimes, these objectives may be imposed from the outside. Equally, they may reflect the failings of the firm’s senior managers.

This situation presents itself most clearly in the case of many state-owned airlines. Almost all governments which still own airlines presumably expect that the carrier should be run to make a profit, to ensure that it is not a burden on the taxpayer. The problem is that either explicitly or implicitly, it is set a series of objectives which make profitability difficult or impossible. Amongst these is the need to maintain services on unprofitable routes for social or political reasons, or to assist economic development of backward regions. Also, airlines may be required to keep domestic air fares artificially low, due to the desire to control inflation, or to maintain unnecessary high levels of staffing because the government wishes to minimise unemployment. Even worse, though not strictly related to the question of objectives, governments often seek to interfere with airline management appointments, with senior management jobs being given to political supporters who have few qualifications to fill these demanding positions. A final, but sadly common problem in the developing world is that government employees and supporters travel a great deal on the national airline, but the government does not then pay the bill for this transportation. Ironically, many state-controlled airlines in developing countries are owed millions of dollars by the governments that own them.

The question of conflicting objectives is most obvious in the case of state-owned airlines, but as an issue it is not confined to them. Many private airlines are in practice operating to a mixed and confusing set of objectives.

Some privately-owned carriers are ego-trips for their owners. This is because aviation is a high profile activity where it is normal to achieve easily a great deal of media coverage. It is remarkable in the airline industry how many small airlines have grandiose names playing on the themes of an “intercontinental” or “world” presence. It is also noticeable that these airlines are often based in an impressive head office described as a “global headquarters” building. A further indication of an airline being driven forward by its owner’s ego is that the owner then ensures that their name is incorporated in the name of the airline and that it is painted on the
side of each aircraft in large letters. Ego-driven airlines are rarely successful because they tend to grow based on the owner’s desire for more publicity and a still higher profile rather than on opportunities for profit. Even if the owner has very deep pockets, there will come a point where losses can no longer be sustained.

A further problem with some airlines is that they are essentially hobbies for those that set them up. Besides being a business, aviation also provides a fascinating hobby for many people. It is one thing to pursue this hobby by plane-spotting. It is quite another to take it to the extent of setting up an airline. Hobby-based carriers only tend to survive if the owner is extremely rich and prepared to lose a great deal of money.

A final, difficult objective for an airline to pursue in practice is that of being a vehicle for revenge. There have been a number of cases where someone who has been fired from one airline sets up a rival carrier designed to allow them to get even with the people who dismissed them. Again, emotion rather than economics will be the driving force behind decision-making and success will be very difficult to achieve.

All-in-all, the foundation for a successful airline must be that the carrier must be profit-based in terms of the objectives it is pursuing. It must also have a clear and agreed strategy, based on the principles which have been discussed in this chapter.

4:5:2 Diversification vs Specialisation

Successful airlines are often those which successfully strike a very difficult balance between over-diversifying and over-specialising.

Over-diversification can take on a number of different forms. In the past, some airlines have diversified into travel-related businesses such as hotel and car rental. At first sight, this appears to be a sound move, allowing carriers to trade on the synergies resulting from being a “One-stop Shop” for the business traveller. It has, though, mostly turned out to be a mistake. It has resulted in a dilution of the top management attention being given to the demanding task of running the airline, and has provided competition for financial resources. More seriously still, it has meant diversification into industries which have exactly the same cyclical problems as the airline business. If airline seats are unoccupied in a downturn, hotel rooms will also be vacant and cars unrented, because suppliers are relying on the same person for each of these activities.

If there is an argument for an airline to pursue a diversification policy into other industries (which is doubtful), a stronger case could be made that they should concentrate on counter-cyclical activities which are likely to remain resilient in a downturn.
Another aspect of over-diversification occurs when an airline tries to cover too broad a route network with too few aircraft. If each route in a network is only served at a low frequency, a great deal of opportunity will still be available for competitors to invade the firm’s markets. Southwest Airlines now has a fleet of more than 450 aircraft, but it still only serves 62 cities in its route network. It has always had a clear policy to build frequency as quickly as possible on a new route, to cement its control of the market. “Do the job properly, or not at all” is a sound maxim.

Despite these arguments, over-specialisation can be an equal problem. It occurs when an airline bets its future on success in a single market. For example, in the past, some airlines (notably so the now-forgotten UK carrier British Caledonian) have tried to build a route network concentrated on serving oil-producing regions. Such a policy will work well when (as at the time of writing) the oil price is high, but will fail disastrously during times of oversupply and low oil prices.

4:5:3 Pace of Expansion

A difficult issue with regard to successful strategies is that of the appropriate rate of growth which the airline should aim to achieve.

It will be hard to ensure success without growth, for two reasons. Firstly, as they mature, airlines tend to find that their costs rise. This is mainly because many groups within the airline are paid according to salary scales which means that their pay increases each year that they remain on the payroll. Growth means that new members can be recruited at relatively low salaries because they will join at the bottom of their pay scale. Secondly, unless an airline grows it will not be taking advantage of new market opportunities as they become available. Besides a possible loss of profit, there is a strong likelihood that these opportunities will be taken up by competitors who will use them to further build the strength of their competitive challenge.

In the airline industry there is another, peculiar factor ensuring that growth opportunities need to be taken, reflecting the way in which airport slots are allocated. If an airport still has slots available, there is strong pressure on an airline to grow and use them because, once they have been obtained, they will be almost certainly be kept forever under the in-perpetuity principle of ‘Grandfather Rights’ which underlies slot awards. Much the same applies to the route licenses which are still necessary to take advantage of international Traffic Rights negotiated under the terms of Air Services Agreements.

Growth rates can, though, easily become over-ambitious. If a carrier attempts to grow too quickly, it will run the risk of becoming dependent on
borrowed rather than equity capital. In turn, this may mean exposure to exchange rate and interest rate fluctuations. Also, over-rapid growth may mean that an airline falls apart operationally. Airlines are a very complex interacting system where all aspects of the system must be functioning well together. If one component is fails, then the whole is at risk. At the extreme, this may manifest itself in a poor safety record and the disastrous consequences of a fatal accident. A less severe, but still serious, problem might, for example, be that potential customers are unable to make bookings because of a shortage of reservations capacity.

Of all the airlines that fail, a proportion do so because they do not grow fast enough. A far greater number, though, go out of business because of over-rapid expansion – a salutary lesson, perhaps, for those European Cost Leader airlines which, at the time writing are attempting to grow at rates exceeding 30% a year.

4:5:4 Competitive Response

Successful airlines tend to be those that manage their competitive strategies well, and unsuccessful ones those that fail to do so. This is especially a problem for new, small carriers.

When a small, start-up airline first begins to fly, it poses a difficult problem for its larger, more powerful rivals. These carriers may launch a vigorous competitive response, and make life very hard for the newcomer. If they do though, they will be spending a great deal of money to deal with what is a minor threat to them. In particular if larger airlines respond with aggressive pricing, they will certainly be competing with a smaller rival. What they will also be doing, though, is offering discounted fares to the many customers who would have flown with them anyway. Because of this, they may be reluctant to respond strongly at first to any challenge. They may also fear that, if they do, they will be exposed to court action over allegations of anti-competitive behaviour.

Because of these factors, a small new airline may often find that its early days of flying are marked by considerable success. On the basis of this, plans are then formulated for rapid expansion. These plans are usually helped by aircraft manufacturers being willing to offer large numbers of aeroplanes at low prices, and by suppliers of finance being quite happy to accept risk based on the asset value of these aircraft, or to lease aircraft on flexible terms. Unfortunately, once the expansion has begun, the new airline changes from an irritant to a significant threat to its more powerful rivals. It must then anticipate a strong competitive response, a response which will be especially serious if it coincides with a cyclical downturn as the industry enters a recession.
As we have seen, the aviation industry never seems to have a shortage of start-up entrepreneurs, wanting to set up airlines. Even severe recessions do not dampen this enthusiasm – indeed they may increase it due to the cheaply-available resources which are on offer at such times. All the evidence of history, though, says that most of these airlines will fail, many after a very short time. Since the liberalisation trend began with so-called US domestic deregulation in 1978, the proportion of failures has exceeded 90%. Many have failed because they underestimated the response of threatened, more powerful competitors. ‘Don’t get into a bleeding match with a blood bank’ is a sound and necessary piece of advice.

4:5:5 “Control”

The “DotCom” excesses of the period from 1998 – 2000 demonstrated many important lessons for airlines. Too often, the entrepreneurs who set up dot.com businesses were seduced by the lifestyle that sudden wealth made possible, and lost sight of the fact that any business needs to meet a worthwhile set of customer needs and to charge profitable prices. The trappings of a supposedly successful business such as expensive cars and prestigious offices make no contribution to this.

Airlines have just as much to fear. Some have failed because large sums have been spent on building an expensive head office building and on funding the lifestyles of the Directors and Senior Managers.

4:5:6 Over-optimism/Fall Back Position

No-one who chooses to work in the aviation industry should be under any illusion. It will be a roller-coaster ride. Periods of relative prosperity will alternate with times of real difficulty, with recessions and now wars and the threat of terrorism providing daunting challenges.

In such an industry, the most fatal business plan of all will be one which is based on the principle, “if everything keeps going our way, we’ll be fine”. Business plans have to be resilient to deal with sudden increases in uncontrollable costs such as the price of fuel. They have to address the likelihood that demand and particularly yield will from time-to-time fall away badly as a recession bites or a destabilising war or terrorism incident affects the industry. They especially have to deal with the likelihood that a whole set of unfavourable circumstances may arrive at the same time, as they often do.

In order to be able to do so, they need to have a fall-back position, the components of which will include a number of expedients. They may, for example take a proportion of their aircraft on relatively costly short-term
operating leases, allowing for the return of aircraft to lessors if trouble strikes. Also, a proportion of support services can be bought in on a sub-contracted basis, allowing contracts with suppliers to be renegotiated in a down-turn.

This chapter on Airline Strategies has inevitably been long and involved. The whole subject, though, is of vital importance. No airline can hope to implement successful marketing policies unless these are underpinned by a sound strategy.

SUCCESSFUL AIRLINES ……

➢ Are those which design and implement a sound strategy