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EU Airline Industry: Low Cost Carriers vs. Incumbents

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Abstract

For many years the air transport market in Europe has been very stable due to government regulation, however, with the deregulation started since 1993 number of important areas of Community legislation were altered; carriers were given more freedom and they found themselves in the situation where they had to make decision for their well being themselves. In addition the deregulated environment paved the way for the emergence of low cost carriers, which actively engage in competition with incumbent airlines.

The objective of this thesis is to study:

- What are the forces shaping strategies of both incumbent and low cost airlines?
- What are the strategic options of incumbent airlines in competition with low cost carriers?
- What might be the possible consequence(s), is there a threat for incumbents in competition with low cost airlines in short- term or in future?

For answering these questions initially Michael Porter's theories on industry structure and competitive strategies were described, in addition for understanding future possible developments George Day's scenario for industry shakeout's was developed. Special concepts for understanding airline industry were also examined. Following an exposition of the air transport legislation within the Community was made, where the most important areas were discussed. With this background I proceeded to the analysis of the five forces shaping strategies of the airlines. It was found that the regulated environment served as the most important force for shaping strategies of the incumbent airlines, while cost factors served as driving forces for shaping strategies of new entrant low fare airlines in the deregulated environment. As for the strategic options available for incumbents in competition with low cost airlines, cost reduction, alliances, code-sharing, price fixing and predatory pricing were identified. Out of these options it was found that cost reduction and alliances are the most frequently exercised options. It was concluded that the consequences of competition are not threatening for incumbents in the short-term perspective, however, if they do not adapt to the changed macro environment their customers might be lured away by competing low cost carriers.

Abbreviations:

IATA International Air Transport Association

DM Maersk Air

BA British Airways

FR Ryanair

SK SAS

VST Stockholm Vasteras Airport

STN London Stansted Airport

GOT Gothenburg

OSL Oslo

NYO Stockholm S. Skavsta

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EU Airline Industry: Low Cost Carriers vs. Incumbent Airlines

1. Introduction

1.1 Background

For many years the air transport market in Europe had been very tightly regulated and consequently stable, since national governments had control over the operations of their national flag carriers and bilateral agreements between EU member states and third countries made it possible for carriers to operate in a situation where they faced virtually no competition and earned stable profits. However, with the deregulation of European Air Transport, which started in 1993 and reached final stage in 1997 the situation changed quite much. Deregulation altered several important areas: policy measures regarding airline licensing of air carriers, access to air routes, fares and rates for air service, slot allocation at airports, computerized reservation systems, groundhandling services - the service, which is provided at the airport in connection with arrivals and departures[1]; airport charges. In addition competition rules, covering concentrations (mergers and alliance), dominant positions, distortion of competition and state aid, were also made applicable to air transport. All these regulatory changes together with the fact that the deregulation gave incumbent airlines certain degree of freedom to act according to their own perception of surrounding environment and adapt to it appropriately placed incumbent airlines in a new and never before experienced situation.

In the aftermath of deregulation the number of airlines operating in Europe turned out to be quite large. In addition, liberalized rules paved the way for the emergence of new entrants – low cost airlines, thus adding additional capacity to the European Air Transport market. Not only legislative changes had impact on the industry. The events of September 11, also served as a strong hit for incumbents and made many managers doubt the viability of the present situation.[2] Thus in this chaotic situation there have to be certain strategic options, which incumbents might use to protect themselves from the increased competitive pressure.

1.2 Problem

The current situation in the European Airline industry can be characterized as turbulent. A number of low cost carriers entered competition with incumbent airlines, since new entrants started operations on some of the markets previously "belonging" to incumbents and put increased competitive pressure on them. Not only did new entrants take a small market share from some of incumbents but also some of them are planning and already carrying out wider expansion plans on the markets of incumbents. For instance, Ryanair's expansion in Scandinavia, since 1997 has been quite active and it has growing trend.[3] As the CEO of Ryanair – Michael O'Leary puts it: "Ryanair is going to be a monster in Europe within the next 10 to 12 years".[4] Other low cost carriers seem to be following the same path. On the 8th of May, 2002 Easyjet announced the deal about the purchase of British Airways German subsidiary, the acquisition will make Easyjet the biggest low cost operator in Europe and bring to it one of the most lucrative European markets – Germany.[5] In the perspective, it looks like incumbent airlines

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[1] Luftfartsverket, Annual Report 1995

[2] Hodson, C., (2002), "Which of Europe's Airlines will survive?", http://www.cnn.com/world, October 4, 2001

[3] "Ryanair in Scandinavia", presentation available at http://www.ryanair.com

[4] Tierney, C., & Capell, K., & Matlack, C., (2002), " Day of the discounters", Business Week, February 11 p. 16

[5] "EasyJet buys BA's German Subsidiary", http://www.airwise.com, May 8, 2000

might be forced to give up some of their profitable routes and thus market share and revenue generated from it. In addition with the final deregulation, air transportation legislation has changed to reflect the altered situation. The legislative framework needs to be studied in greater detail to get a complete picture of what the current applicable “rules” are for the airlines.

1.3 Research Question

Following the background and problem discussion I would like to pose following questions for my research:

- What are the forces shaping strategies of both incumbent and low cost airlines?
- What are the strategic options of incumbent airlines in competition with low cost carriers?
- What might be the possible consequence(s), is there a threat for incumbents in competition with low cost airlines in short- term or in future?

2. Methodology
2.1 Research Method

My research is aiming at describing and explaining the competitive forces shaping the strategies of both incumbent and low cost carriers, as well as studying reaction and strategic options of incumbent airlines to the entry of low cost carriers to their markets since the research of all these questions helps to identify the consequences of competition for incumbent airlines short term and makes it possible to make judgment about the future. The situation in the industry has evolved over time, due to changes in competitive environment. The situation can be characterized as quite dynamic and that is why I decided to use qualitative method for my research.
As I have stated above I will make description and explanation of the competitive forces shaping the strategies of airlines. I will make this by using appropriate theory, which will be addressed in 2.2. Examining the community legislation before and after deregulation is an important issue, which will be addressed to describe current legislative framework, which influences the activities of airlines to certain extent. As for the study of reaction and strategic options of incumbent airlines, I decided to use the qualitative approach, which helps to give a more comprehensive picture of the situation in the airline industry. After portraying the whole picture of the situation I decided to involve case study of competition between SAS and low cost carriers: Ryanair and GO, both of which are operating on Scandinavian market. This case study is very helpful in identifying consequences of competition for incumbent airlines short term and make judgments about future developments since it explains the view on the competition of both incumbent and low cost carriers, provides information about development of competition by suggesting different patterns of low cost carriers' operations development. This case study helps to study few objects in a variety of aspects as it can be assumed from above statement and it can be used as an illustration. Nonetheless, this case study can not represent all aspects of the whole European Airline industry offering scheduled services, due to the differences prevailing in different markets, however, it still can serve as an indicator of the competition trends that can be found among the companies operating within the airline industry.
While the part of the research preceding case study is based on theory and historical development of situation, which are backed by appropriate examples, and thus provides more or less objective judgment, the case study of the research, makes subjective interpretation of certain aspects unavoidable to certain extent.

2.2 The Role of Theory

Michael Porter's[6] theory on the competitive forces, provides the basis for my analysis. These forces influence and shape the structure of the industry while helping companies operating within the industry to define their competitive strategies in different business environment. The information that has been collected during my research fits into different parts of this pattern. As the situation in airline industry is quite turbulent, and the strategies of the airlines are forever changing due to the changing macro environment, it is most suitable to use the theoretical approach, which I decided to use since it helps to describe and explain the strategic options of incumbent airlines effectively as well as helps to better understand the strategies of low-cost carriers. In addition to Porter's[7] theories I use the theoretical pattern by George Day[8], which suggests the developments of the reshaping of industries, which can easily be applied to airline

[6] Porter, M., (1980) "Competitive Strategy, Techniques for Analyzing Industries and Competitors", MacMillan Publishing Co. Inc., New York p. 4-25 and Porter, M., (1990) "The Competitive Advantage of Nations", MacMillan Publishing Co. Inc., New York p. 12-26
[7] refer to note 6
[8] Day, G., (1997) " Strategies for surviving shakeout", Harvard Business Review, March-April, p. 93-102

industry. Further in order to better understand the peculiarities attributed to airlines I have borrowed specific concepts from Hannu Seristo[9].

2.3 Mode of Procedure

At the beginning of the research my knowledge of the airlines industry was quite limited. In order to increase my understanding of the field I started looking for the material in the libraries and in databases, where I found different books, articles and research reports. This preliminary investigation helped me to define the framework and objective of the thesis. Afterwards the research was continued in the libraries. When the case study stage of the research was reached both incumbent and low cost airlines were contacted, however, the response was only received from the incumbent. Because of this the objective of the thesis was modified somewhat, according to the information I obtained and what proved unobtainable. Throughout the research I tried to study and analyze the collected material in order to structure it into a comprehensive unit where a problem and objective were met.

2.4 Data Collection

The data used in the thesis encompass both primary and secondary data. Even though the secondary data has been previously used in other researches it is nevertheless readily available and some useful data can be extracted. Though the effectiveness and bearing of the secondary data will not be as relevant as primary data, it is nonetheless means of providing an insight into the project. In addition gathering of secondary data incurs less time and cost than a more expensive and time consuming primary data. A wide range of sources providing secondary data was found, which contained both general and specific information. The sources include books, research reports, Community legislation, economic journals, business magazines, newspaper articles, annual reports and etc.

As for the primary data it was obtained from SAS, which provided good understanding of the company's position and its perception of the environment and its role and position within the industry.[10]

2.5 Data bases on CD-ROMS

CD-Rom's containing back issues of newspapers (The Financial Times, The Sunday Times, The Wall Street Journal) were examined. And periodicals were also scanned (The economist). Key note was useful CD-Rom, which provided market research information on the airline and airport industry and individual firms.

2.6 Internet

Internet provided useful information. Web site of Ryanair, Easy Jet, GO and SAS were surfed. Even though most of the information was suited for customers, I still managed to get some insight of the companies. Unfortunately, the email addresses of the employees were not listed on the sites and thus only private contacts made it possible to establish contact with SAS.[11] Thomas Wandahl, the Sales Director at the SAS, was extremely helpful in providing the necessary information and promptly replied to my queries on the airlines industry.

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[9] Seristo, H., (1993) " Airlines Strategies: Deregulation of the European Airline Industry" HSE Press Helsinki, p. 83-101

[10] Refer to 2.9

[11] See note 10

Further I would note that interesting and important news were gathered from daily news site in airline industry available at http:///www.airwise.com and http://cnn.news/world.

2.7 Source Critique

Many of both primary and secondary sources e.g. annual reports, company representative speeches and reports, are of the subjective nature, and subsequently tend to put the company in a favorable light. However, most if the qualitative information from these sources could be checked with neutral sources of information from, form example industry organizations.

2.8 Outline

In order to understand the strategic options of the incumbent airlines after the emergence of the low cost carriers and the consequences of the competition between them it is first of all necessary to understand the forces shaping the strategies. The link between the industry structure and the strategies of the companies is direct and can be described by Porter's theory on competitive strategies. With this understanding the reader hopefully will understand the implications of the Community legislation that have developed with the deregulation of the industry and emergence of low cost airlines. The community legislation has to be reviewed in order to understand the situation of both incumbent and low cost airlines. An empirical analysis will follow applied to the theories described previously. Based on which strategic options of the incumbents can be identified. Case study emphasizes competition issues and consequences, which will be followed by future trends and conclusions.

2.9 Limitation

The research is limited to airlines dealing with passenger traffic, and thus I will not touch upon cargo traffic. As for the passenger traffic it can be divided into scheduled and charter traffic. These two categories are sometimes hard to distinguish. However, most of the airlines engage themselves in one of these at a time and primarily I am going to focus on scheduled traffic. The charter traffic might be approached in case of its relevance to overall picture of the research.
Since the research has certain limitations in time and allocated funds I am going to identify the consequence of the competition between the incumbent and low cost airlines by using only one case study involving SAS and low cost airlines operating in Scandinavia.
As I mentioned in 2.6 I managed to establish contact with SAS during my research, however, it proved impossible to get in touch with the employees of low cost carriers. Thus the case study research might be influenced by a more subjective judgment towards SAS, since the internal sources of information were obtained only from this company and it was not possible to receive the same kind of information input from low cost carriers. It also should be noted here that I decided not to conduct interviews since as I mentioned above it proved impossible to contact low cost carriers, while on the other hand the information obtained from SAS was quite exhaustive since it fully reflects the company's perception of the environment around it together with its prospective role in the airline market.

2.10 Further Research

It will be interesting to further research the possible ways of cost cutting for the incumbent airlines:

- How can this be achieved?
- What implications will cost cutting have on the entire industry?

3. Theory

To build broad theoretical framework for organizing analysis of my research in the airline industry I decided to rely on Michael Porter's theories.[12] In addition, for describing future possible developments of the industry I considered George Day's[13] views on the industry as a reliable theoretical pattern. For understanding concepts specific to airline industry I use explanations suggested by Hannu Seristo.[14]

3.1 Structural Analysis of Industries

It is extremely important to understand the structure of the industry since it shapes the strategies of the companies to considerable extent. Industry structure can be defined by five competitive forces. They are as flows:

1. The threat of new entrants
2. The threat of substitute products or services
3. The bargaining power of suppliers
4. The bargaining power of buyers
5. The rivalry among existing competitors

3.1.1 The Threat of New Entrants

There are six important barriers to entry for the potential new entrants:
Economies of Scale. This describes the situation when the cost of producing a product decreases as the absolute volume per unit of time increases. When the competitors of the industry have the advantage of operating on large scale, the potential new entrants are deterred from entering the industry, as they are either required to begin producing large quantities and consequently be faced with reactions by the competitors, or begin by producing in small quantities and have relative cost disadvantages to their competitors.
Product Differentiation. This regards the customer loyalty enjoyed by companies that have advertised, provided customer service, differentiated their products, or been the first company in the industry. Customer loyalty takes time to achieve and requires large investments.
Access to Distribution Channels. The new entrant has to secure itself access to distribution channel for its products by convincing distributors to take its products. The competitors in the industry might have a long history with their distributors, have tied them up well, provide exclusive products and established contracts guaranteeing exclusiveness in the distribution of its products.
Common Costs. This occurs when a company that produces product A also has to have the capacity to produce product B. For instance, a commercial aircraft can only utilize a certain part of the aircraft for passengers, due to technical restrictions. The rest of the capacity can be used for luggage and cargo. The costs for the flight can be divided between the two (passengers and cargo), which creates an advantage relative to the competitors that only compete in one of the industries, for example only the luggage industry.
Capital Requirements. The need to invest in large amounts of capital to compete creates a barrier to entry, particularly if the capital is required for risky investments or single large investments, such as basic advertisement or R&D. Further capital requirements relate to customer credit, stocks or coverage of initial losses.
Cost Disadvantages Independent of Large Scale Production. These advantages obtained by the competitors of the industry, cannot be copied by potential entrants, regardless of the size of

[12] see note 6
[13] see note 8
[14] see note 9

the production and economies of scale and scope. Examples of these are patents on production technology, favorable access to raw materials, good location, state subsidies.

3.1.2 The Threat of Substitute Products or Services

If there are products or services that can substitute those offered by the industry competitors, the level of competition rises. The competition is mainly concerning price, in this case where lower prices of substitutes will result in an erosion of industry volume sales. Substitute products can be defined as products and services that can perform the same function as the industry's product or service.

3.1.3 The Bargaining Power of Suppliers

Suppliers are trying to get as profitable situation in the industry as possible. Hence, they will try to bargain away profits for themselves, by demanding the highest possible price from their customers. Powerful group of suppliers in the industry can be characterized as follows. First, the suppliers industry is more concentrated than the industry it supplies. Thus suppliers can put and keep pressure on customers in terms of prices and quality. Second, suppliers do not compete as intensively with other substitute products/services for the sales to the industry. Third, when the supplied industry does not represent an important customer for the suppliers. In this case suppliers can have more power of customers. Fourth, the power of suppliers is important if the product supplied by them constitutes important component of the of the buyer's operations. Fifth, when the suppliers sell differentiated products/services or have built up switch-over costs, the buyer will not have the same possibility to set off the suppliers against each other. Personnel also represent suppliers. The degree of their power is determined by how much the group of trained and educated personnel will expand and how well organized they are. The more organized and the less expanded they are, the greater their power.

3.1.4 The Bargaining Power of Buyers

The buyers also aim to bargain profits away for themselves. They can push down prices negotiate for higher quality or more services, and play out the competitors against each other. The severity of this threat for the industry firms is determined by several factors. First, how concentrated are the buyers and the purchase volume in relation to the suppliers' sales? Second, how important is the product/service supplied by the industry for the buyer's costs or purchase? Third, are the products/service undifferentiated or standardized, giving the buyer a wide selection of suppliers to choose from? Fourth, are there few switch-over costs, making it easier for the buyer to switch to another supplier? Fifth, are the buyers experiencing low profits that makes then price sensitive? Sixth, are the buyers likely to integrate backwards, putting then in a position to bargain? Seventh, is the production/service important for the quality of the buyer's products/services? The more important it is, the less price sensitive the buyer will be. Last how much information do the buyers have on the market prices and the suppliers' costs? The more information the buyers have access to the more powerful their bargaining power will be.

3.1.5 The Rivalry among the Existing Competitors

The more intense the rivalry between the existing competitors, the lower the earned profits. The reason can be attributed to increased costs for competing, such as increased allocation of financial resources to advertising, sales and R&D, and/or offering the product/services at lower prices. On the other hand, a lower degree of rivalry will increase profits earned by the competitors, who will try to counteract the threat. You can say that the companies are reciprocally dependent on each other. A number of interactive factors influence the competition in the industry. They are:

Many or Competitors having equal merits. When there are many competitors the possibility of companies believing that they can take competitive actions without being noticed is quite big. If on the other hand there are a few companies that are equal in terms of size and observable resources, the competition can be harsh and long-lived.
Absence of Differentiation and Switch-Over Costs. The more standardized the product or service is perceived to be, the more likely it is that the customer's choice is based on price and service, which intensifies the price and service competition.
High Strategic Value. The competition of an industry intensifies when several companies find it of utmost importance to succeed in that industry, even by sacrificing profits of necessary.
Heterogeneous Competitors. Competitors that divert in terms of strategies, origin, personnel and its relation to its parent company, have diverging goals and strategies for competition will consistently collide on the market. It will be difficult for them to interpret each others intentions and agree on the "rules of the game" for the industry.
Capacity Increase. Large scale production that is favored by capacity increases by leaps will disturb the demand/supply situation in the industry, leading to periods of overcapacity and price decreases.
Large Exit Barriers. These consist of financial strategic and emotional factors, which makes a company stay on the market, despite low profits or negative results. The most important reasons could be contributed to specialized assets, fixed discontinuation costs, strategic mutual importance between units of the company, emotional obstacles and government and societal obstacles. The result will be over capacity in the industry and consistently low returns.
Changes in Competition. The factors shaping the intensity of competition can change and they do so. Examples of these factors are the growth of the industry, company acquisitions and technological innovations. Companies respond to these changes by strategic changes, which involve an increase of the customers' switch-over costs, tailoring products for specific purposes, avoiding confrontation with competitors that have high exit barriers, or lowering its own exit barriers.
Entry and Exit Barriers. Often entry and exit barriers have connection within each other. Porter described this relationship in a model:

	Exit Barriers Low	**Exit Barriers** High
Entry Barriers Low	Low, Stable returns	Low, Unstable returns
Entry Barriers High	High, Stable returns	High, Unstable returns

Source: Porter, 1980, "Competitive Strategy, Techniques for Analyzing Industries and Competitors"

When the entry barriers are high and exit barriers low, the potential new entrants will be deterred from entering the industry, just as non-profitable companies will leave. In a case where both entry and exit barriers are high the profit potential is substantial, and so are the risks involved. Therefore, risk from new entrants is low and competitors within the industry will stay regardless of their profitability. On the other hand if both entry and exit barriers are low or exit barriers are high new entrants will establish themselves easily in the industry when business cycle is advantageous or there are other opportunities. Nonetheless, capacity will not leave the industry despite low profits, which will increase the total capacity and lower the potential profits of the industry. Even though industry structure tends to be stable, it can change over time. Changes in the five forces will lead to such alterations. The industry trends that are the most important for the firms' strategies, regardless which force they originate from, are those that have the most impact on the industry structure. For example, the introduction of computer information systems in the airlines industry raised the barriers to entry, as the investments required to enter that industry were increased.

3.2 Competitive Strategies

According to Michael Porter[15] sustainable competitive advantage is gained through the fundamental basis of above-average performance. A firm can possess two basic types of competitive advantage: low cost or differentiation. These strategies combined with the number of activities a firm tries to achieve result in there generic strategies: cost leadership, differentiation, and focus strategies.

Competitive Advantage

Competitive Scope	Lower Costs	Differentiation
Broad Target	Cost Leadership	Differentiation
Narrow Target	Cost Focus	Differentiation Focus

Source: Porter, 1985, "Competitive Advantage: Creating and Sustaining Superior Performance"

Cost Focus strategy requires tight cost control in all areas of operation, and may require some up-front investment so that efficient scale is achieved. In airline operations cost leadership strategy has so far been associated with differentiation in the sense that most low-cost carriers traditionally have provided services with no advance boarding passes, no baggage transfer handling, and no meals on-board. However, a cost leader cannot ignore differentiation. If its products are not acknowledged by buyers as comparable to other carriers products, low cost airline will have to discount tickets much more than competitors to make sales possible. That was of one the Ryanair's problems. However, it initiated improvements in marketing, service and to travel agents and passenger service.

Focus strategy in airline business can be pursued through two basic focusing approaches: an airline can focus either on particular geographic area or on certain customer segment. As to geographic focus, firstly, an airline can provide regional services. In Europe an example can be a network within the Nordic countries, using aircraft that are most suitable for flights of less than two hours of duration. Secondly, an airline can provide only long-haul services, and possibly use only certain type of wide-body aircraft. Thirdly, an airline can concentrate on some geographic area where it has specific advantages. As for the focus based on customer segments, it might be spread between business, tourist and other segments.

Differentiation strategy implies that the product of the company should be differentiated to the extent that it is seen as something unique within the industry. That is what we see with Ryanair, which in addition to offering cheap flights also decided to attract customers with innovations. Very soon the company will start giving out free flights to passengers, however, they will have

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[15] see note 6

to play in onboard casino or purchase some kind of product onboard. The CEO Michael O'Leary is already trying to find ways adjust the Boeing for this purpose. "We want to become Las Vegas in the Air. And that's fully legal"- claims he. And Swedish air traffic authorities seem to agree to this new approach. Ulla-Clara Brask, from the Press Department of the Board of Air Traffic " As long as Ryanair meets the requirements of traffic and passenger fees we do not have any intention to interfere with their marketing strategies".[16] Even though passengers should not have luggage and they will not be served meals on board still there will be many curious people who would like to try this new Las Vegas in the air. Another example of differentiation can be British Midland, who on the 30th of April of the current year became the first airline to install instant medical diagnostic equipment on its long haul services. The device provides a direct link with doctors on the ground, who provide further advice on how to act in various cases if either passengers or crew are taken ill during a flight. Austin Reid, British Midland's CEO said: "By installing this ground breaking system on our transatlantic services from Manchester, we are able to ensure that the best possible medical advice is available to our passengers while making the transatlantic crossing, irrespective of the aircraft's altitude or distance from land."[17] Thus passengers having some kind of health problems will fill much eager to fly with the company where they can get, medical assistance in case of emergency. And of course this kind of differentiation is a very good tool for attracting passengers with health problems. However, in addition to offering exciting product it is also important to have appropriate configuration of route network. Incumbent airlines prefer to operate in a coordinated hub-and-spoke system, offer a high frequency and great variety of flights. Heathrow is a good example of such hub, which is very popular both to major airlines and business travelers since it provides opportunities for connection as a consequence of the multiplicity of incoming and outgoing flights. As for the low cost airlines, they prefer to use secondary airports and operate point-to-point system. As a rule those secondary airports charge lower landing fees, and car parking costs are less for employees.

3.3 Possible Future Development

Not only the five forces described above should influence the strategies pursued by airline companies but it should also be seen that because of the current increased competition, which I touched upon in 1.1 and will be further discussed below, it seems that there are only two possibilities available for the near future: wise restructuring of the industry or serious detrimental shakeout. These factors are to be taken into account by airline companies and they should work out strategies, which will help them survive. According to George Day "a shakeout threatens all companies in a market , but it offers an opportunity to those who see it coming and can anticipate the path it is likely to follow. All shakeouts remove excess capacity from an industry, each with its predictable pattern, each following a different economic logic."[18] He also argues, that managers are able to cope with uncertainties better and help companies through the consolidation process. According to Day's division of industries subject to different shakeouts, I would put European airline industry within Seismic-Shift category, the syndrome, which strikes stable, mature industries, which enjoyed protected prosperity over considerable period of time. Out of the causes Day suggests for the shakeout, I have chosen three, which are relevant for the airline industry and they are: **Deregulation**, which is quite serious step in the airline industry, which actually changed the working of the whole industry; **Globalization**, in the airline industry refers to the extent to which airlines of different countries add to their services routes between different countries, and thus increase the load level, which in turn influences the income of the company; **Emergence of "Competence Predator"**: Competency predators are innovators that have developed a new business model that offers the possibility of large economies of scale. Once they have mastered a competency in a given market, they enter new regions. They are able to

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[16] Hansson, A., (2002) "Gratis flyg – om du spelar pa kasino", Aftonblandet, April 11
[17] "Bmi First With Instant Health Checks", http://www.airwise.com, April 30, 2002
[18] see note 8

come out of nowhere and grab large shares in market that welcome the new level of service or sharply reduced costs. That is more or less the situation observed with newly emerged low-cost carriers, which conquer and establish themselves on markets quite fast. George Day also claims that shakeouts can be overcome, if scenarios for operating on the market different from the present one are developed. Each scenario should be a consistent picture of the future that addresses the four critical questions:

- How many competitors can the market support in the long run?
- Which trends are likely to trigger a shakeout?
- Which competitors – present and prospective – have staying power, and which are vulnerable?
- Can the company benefit by accelerating the shakeout's arrival?

3.4 General overview of the Airline Industry

Travel and tourism is the largest industry in the world, with annual sales of 3,000 USD. Travel and tourism meets an annual payroll of 730 billion USD providing one of every 15 jobs in the world, it pays 6% of the world's total taxes, and accounts for more than 9% of all capital investment.[19] Airline industry is the part of a larger air transport. The biggest air transport market is clearly USA. The other major markets in descending order of size are trans-Atlantic, intra-European international, trans-Pacific, Europe-to-Asia, and intra-Asian.[20] Europe's share of worldwide international passenger traffic amounts to 58.0%. The combined domestic and international passenger traffic was estimated at 541 Million passengers in 1998 and 2015 the traffic is expected to double. The projected average annual rate of growth is 4.8% between 1998 and 2005, 4.0% between 2005 and 2010, and 3.8% between 2010 and 2015**.** Out of the European markets United Kingdom is and the dominant traffic market. By 2015, 310 million passengers will travel to, from and within the United Kingdom. Europe's other major markets in 2015 will be Germany, Spain, France and Italy. As a result three of the Europe's biggest carriers are among the world's top Airlines.

World's Top Airlines 1999[21]
(rankings)

Revenue	Passengers	Employees	Fleet Size
1. United	1. Delta	1. UPS	1. American
2. American	2. United	2. FedEx	2. FedEx
3. Japan Airlines	3. American	3. United	3. United
4. Delta	4. Southwest	4. American	4. Delta
5. FedEx	5. Northwest	5. Delta	5. Northwest
6. British Airways	6. US Airways	6. Lufthansa	6. US Airways
7. Lufthansa	7. Continental	7. DHL	7. Continental
8. All Nippon	8. All Nippon	8. Air France	8. Southwest
9. Northwest	9. Lufthansa	9. British Airways	9. British Airways
10. Air France	10. Air France	10. Northwest	10. Lufthansa

[19] Seristo, H., (1993), "Airline Strategies: Deregulation of the European Airline Industry", HSE Press, Helsinki p. 68
[20] refer to note 13
[21] source: http://www.aviationglobalization.net

3.5 Concepts for understanding Airline Industry

3.5.1 Hub-and-spoke System

Hub-and-spoke network means that there is one central airport called hub, where flights from other airports called spoke airports converge.[22] In Europe hub-and-spoke system has been in use for a long time due to the simple fact that national flag-carriers have usually had one main airport where they operate from. In a hub-and-spoke network with N spoke cities the maximum number of indirect connecting city-pair markets is N(N-1)2. According to Seristo[23], in the five cities example an airline could serve 4X3/2=6 connecting city pair markets from its hub C.

There are several advantages of hubbing. First, travelers have to make fewer stops than in sequential system, which implies adding some stops along the route in order to increase the demand base. Secondly, the airline can consolidate its maintenance and ground functions at the central hub location. Third, the airline can offer a wider range of destinations with a smaller investment in flight time. Fourth, building a strong hub puts the airline in a virtual monopoly status at the hub airport because it has control of gates and slots.

As to the economic effects of hub-and-spoke structure a study conducted by Borenstein[24] should be mentioned. His study indicated that airline charged higher prices when it had a dominant position at an airport, and at these dominated airports the airline generally charged higher prices than elsewhere in its routes system. Interestingly the market power of the dominant airline did not spill over to other airlines serving the same airport. Similarly airlines that dominated a route were charging higher prices than on other routes where they had no dominant position.

Airlines operating largest hubs secure the most benefits since they are able to offer widest choice of destinations. Thus hubs are very popular with large airlines such as SAS, BA, which benefit from its strong presence at well-defended hubs in Copenhagen and London/Heathrow respectively. Dominating carriers can possess competitive advantage over rivals. They can earn higher profits and they can increase market share through more aggressive pricing. Further advantages according to Lynch[25] are associated with priority airline service and take off and landing slots are awarded to those controlling the airport.

However, hub-and-spoke system has its weak points too. Namely, it is possible that all flights are not evenly occupied. Therefore it can happen that for a traveler planning to make a journey composed of two or more separate connecting flights, one of the “legs” is full, even though the other leg could be almost empty. In this case the airline may lose this potential passenger just because a portion of the trip was full.

As Furgeson[26] noted hub operation results in additional landings and take off which give rise to associated airport charges and increased fuel costs. Aircraft utilization is likely to decrease as the system results in more time spent on the ground. The airlines must also make sure that the service of aircraft each day starts from spoke airport, which involves management of dispersed crew and maintenance facilities. A hub-and-spoke network also places demand on availability of landing and take-off slots together with the availability of air space over the hub airport at specific times. Hence, large number of incoming flights must converge in the hub. Since most customers prefer direct flights, they should be arranged so that they limit transfer and waiting time. This requires connecting flights, which have to converge on the hub at the same time and efficient transfer arrangements for both passengers and baggage.

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[22] refer to appendix 1
[23] see note 9
[24] Borenstein, S., (1989) “Hubs and high fares: dominance and market power in the U.S” Rand Journal of Economics, Vol.20 No.3 p. 7
[25] Lynch, R., (1990), “European Business Strategies”, Kogan Page, p. 30
[26] Furgeson, P.R., & Ferguson, G.J., Rothschild, R., (1993), “Business Economics”, Macmillan Press LTD. p. 22-23

Not only airlines compete but also there is competition involved among airports. Airlines work hard with airport authorities to get better transport links to make that particular airport more attractive for passengers.

3.5.2 Point-to-Point System

Using point-to-point system customers fly directly to the place of destination.[27] Low-cost airlines, which operate highly intensive shuttle services on busy domestic routes between pairs of cities, are using point-to-point system. According to Virgin executives, Virgin Express will always serve point-to-point and the airlines will not try to build hub-and-spoke network, which is quite expensive and is used by the world's biggest leading airlines[28]. Aircrafts are more fully utilized and passengers spend less time waiting. Moreover, staff is kept fully employed because aircraft follow one another in and out the airport all day, as opposed to peak periods when all flights converge in the hub at the same time. The disadvantage of this system is that fewer destinations can be offered and this causes lack of economy of scope. The lack of destinations does not decrease number of low fare airlines customers that much. According to Stelios Haji-Ioannou "We decided to concentrate on people who go from A to B and back".[29] He also points out that many airlines are trying hard to get involved with alliance to make a global network, however, he does not seem to approve of that much and considers operating point-to-point system to be offering quite much savings.

Easyjet and Ryanair are limited to flying short-haul point-to-point routes due to the low cost under which they operate. For example, the longest route offered by Easyjet is only two hours to Palma, Majorca[30]. If their flight lasted for more than 3 hours then passengers would expect an in-flight meal, and entertainment. Therefore the cost of airline would increase and that would conflict with Easyjet's strategy. The quick growth of low fare airlines means that there is a quite extensive market for the services they provide, and this kind of services were not effectively provided by incumbent airlines.

3.5.3 Alliances

Alliances are a very important tool for gaining competitive advantage. At the same time alliances make it possible to align only for the airlines having more or less same importance and acknowledgment in the business arena. Thus well-established airlines form alliances within themselves clearly neglecting the possibility to align with relatively newly emerged carriers. On the other hand low fare airlines are not interested in alliances either. There are a number of reasons why neither well established airlines nor low fare airlines want to be aligned with each other:

Low-fare carriers do not want the alliance since they

– Would need to change too many procedures to join an alliance
– Additional passengers that an alliance would generate are outside the carrier's niche

Alliances do not want the low-fare carrier since

– Low fare airlines provide little benefit to existing alliance partners
– Service levels are too different from that of existing partners

Currently there are four alliances in the world, which is ranked as follows:

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[27] refer to appendix 1
[28] Maddox, B., (1992), "Tracking Virgin's Vapour Trail", The Financial Times, February 21
[29] Rigby, R., (1997), "Cheap and Cheerful", Management Today, August, p.10
[30] Bowman, L., (1998), "What you see is what you get", AirFinance Journal, February, No. 203, p. 44-47

Merrill Lynch Alliance Index[31]

Name	Star	Wings	Oneworld	SkyTeam
Geographical Network	**1**	**2**	**3**	**4**
Market size	**1**	**3**	**2**	**4**
Network Density	**4**	**1**	**3**	**2**
Financial Strength	**3**	**4**	**2**	**1**
Regulatory Freedom	**2**	**1**	**4**	**3**
Overall Rank	**1**	**3**	**2**	**4**

Three of the European Airlines: Lufthansa, Austrian, British Midland and SAS belong to Star Alliance. British Airways together with Aer Lingus, Finnair and Iberia are aligned with Oneworld. KLM is the only European Airline in Wings, just the same was as Air France in SkyTeam.

3.5.4 Cost Structures of the Incumbent Airlines

Airline costs are an important factor both in everyday running of airlines and in longer-term strategic planning. In the short term the costs have a significant impact on fare-levels, and in the long term the costs have an impact on investment and personnel decisions. According to Doganis[32], the structure of Airline costs looks like this:

Operating Costs

I Direct Operating Costs

a) Flight Operations

- flight crew salaries and expenses
- fuel and oil
- airport and route charges
- insurance
- rental of flight equipment or crew

b) Maintenance and overhaul

c) Depreciation and amortization

- flight equipment
- ground equipment and property
- amortization of development costs and crew training

II Indirect Operating Costs

a) Station and ground expenses

[31] http://www.backaviation.com

[32] Doganis, R., (1985), "Flying off course, The economics of international airlines", George Allen and Unwin p. 45-48

b) Passenger services
- cabin crew salaries and expenses
- other passenger service costs

c) Ticketing, sales and promotion
d) General and administrative
e) Other operating costs

Non-operating Costs

a) Interests paid on loans
b) Losses from affiliated companies
c) Losses from the retirement of equipment and other property
d) Losses from sales of equipment, exchange rate changes, etc.

Of the operating costs, the biggest single cost item is the cost of *flight operations*, which has typically accounted for about 30-35% of the total operating costs. *Flight crews* in European incumbent airlines are generally speaking paid high remunerations in comparison with American and Asian carriers. Another significant item in flight operation costs is *fuel cost*, which can vary quite much from one point of time to another and from one geographic location to another. Fuel costs have accounted typically for 15-25% of the total operating costs, which corresponds to 10 to 15% of the total costs of an airline. As for the oil costs compared to fuel costs they are rather marginal. *Airport charges* comprise a landing fee, which is based on the weight of an aircraft and a passenger fee, which is charged per passenger number. Route charges are usually based on the distance that the aircraft flies in a particular country's airspace, and also on the weight category of the aircraft. *Insurance* offers quite limited possibilities for cost reduction as the insurance premiums due to the international pooling of insurance services are rather similar in all parts of the world. *Rental and lease costs of aircraft and crews* similarly offer very limited cost reduction possibilities. As the aircraft and crew markets are very much international in nature and the assets extremely mobile, the prices are determined mainly by the current demand and supply conditions and an airline to a large extent has to accept whatever price the market has determined. *Maintenance and overhaul costs* include many different cost items, such as various labor costs, spare parts and components etc. Maintenance costs represent some 10-15% of the total operating costs. *Depreciation and amortization costs* include depreciation of flight equipment, ground equipment and ground property. Moreover, crew training costs and development costs can be spread over several years through amortization. These charges represent typically on average about 8% of an airline's total operating costs. *Station and ground expenses* include wages and expenses of the staff engaged in handling and servicing of aircraft, passengers and freight at airports; costs for handling and transport equipment and rents and other costs for building and other facilities. These expenses represent 10-20% of the total operating costs in scheduled internationally operating airlines. *Passenger services* includes wages, training costs, travel and other expenses related to cabin staff and other personnel that is engaged in passenger service. Also in-flight catering costs and costs due to deferred or cancelled flights are included in this cost category, as well as are the premiums paid for passenger liability and accident insurances. Passenger services costs typically make some 10% of an airline's total operating costs. *Ticketing, sales and promotion* are the largest item in most Western flag carriers. These costs include wages, allowances and other items for the staff involved in ticketing, sales and promotion functions, and also such items as advertising charges, promotional travel costs, costs of sales offices, and commissions paid to travel agencies. The average share of ticketing, sales and promotion costs equals 15-18%. *General administrative costs* include all those operating costs that an airline cannot allocate to any particular activity. These costs typically represent 5-10% of an airline's total operating costs.

As for the non-operating costs, interests paid on loans is naturally determined by the amount of loans an airline holds, and by the interest rates it has to pay for those loans. Financing of purchases of ever more expensive aircraft through external sources as opposed to self-generated funds or equity boosts – has driven debt-equity ratios in many airlines into unsustainable levels. Particularly so as the financiers are becoming more cautious due to continuing massive losses, resulting in less favorable financing terms for airlines. As it is quite generally accepted that the debt-equity ratios greater than 100% are alarming, the following ratios of selected European Airlines in 1991 illustrate the situation of many carriers:

Alitalia	80%
SAS	100%
British Airways	120%
Lufthansa	200%
KLM	230%

Source: Seristo, H., (1995), "Airline Performance and Costs", p. 39

Losses from affiliated companies typically mean losses from participation in hotel, travel agency, tour organizing, catering and financing business.
Losses or from the retirement of property and equipment are due to the difference between the depreciated book value of a particular item and the value that is realized when that item is retired or sold off. These losses are determined by depreciation practices of an airline and the prevailing markets for used aircraft or other property at the time of retirement.

3.5.5 Variable and Fixed Costs

Direct costs can be variable or fixes. Direct operating costs that are escapable in the short term are called variable or flying costs. Direct costs that do not vary in the short or medium term but are escapable in the long term (longer than 1-2 years) are called fixed or standing costs. Costs can be categorized as follows:

Variable Direct Operating Costs

1. fuel and oil costs
2. variable flight crew costs
3. variable cabin crew costs
4. direct engineering costs
5. landing fees, airport and en-route charges
6. passenger service costs

Fixed Direct Operating Costs

1. aircraft standing charges (depreciation, rental, insurance)
2. annual flight crew costs (fixed salaries and expenses, administration)
3. annual cabin crew costs (fixed salaries and expenses, administration)
4. engineering overheads (fixed staff costs, maintenance administration and overheads)

Indirect Operating Costs

1. station and ground expenses
2. passenger services
3. ticketing, sales and promotion
4. general and administrative

Source: Seristo, H., (1995), "Airline Performance and Costs", p. 41

4. Air Transportation Legislation within the Community

4.1 Aviation prior to liberalization

Before the liberalization of the air transportation sector, there was a widespread policy of protection for the national carrier. Scheduled airline, which the state concerned secured influence for itself, usually in the form of a majority participation, and which in return for this protection has had to maintain essential communications by way of air services. The protection offered encompassed two areas:

1. protection against foreign competitors, including other scheduled airlines;
2. protection against domestic competitors

Protection Against Foreign Competitors

International air transport is based on rights of access, which the different stated grant one another by multilateral and bilateral air service treaties, or which are granted upon application. The rights of access are internationally generally described by reference to the five freedoms of the air. These are not exclusive, but can be combined. The number of freedoms of the air increased to eight after the Chicago Convention of 1944 on International Civil Aviation. The freedoms are as follows:

1. The right to fly over the territory of a contracting State without landing.
2. The right to land on the territory of a contracting State for non-commercial purposes. One example of this could be technical reasons.
3. The right to transport passengers, cargo and mail from the State of registration of the aircraft to another contracting State, and to set them down here. This grants permission for an aircraft to operate one-way service.
4. The right to take on board passengers, cargo and mail in another contracting State and to transport them to the State of registration of the aircraft. This grants permission for an aircraft to operate round-trip services. The third and fourth freedoms form the basis for air transport between two states.
5. The right to transport passengers, cargo and mail between two other States as a continuation of or a preliminary to, the operation of the third and fourth freedom, by extending the transportation to third states. It requires the right of access by the third state concerned.
6. The right to take on board passengers, cargo and mail in one state and to transport them to a third State after a stopover in the aircraft's state of registration and visa versa.
7. The right to transport passengers, cargo and mail between two other States on a service, which does not touch the aircraft's state of registration.
8. The right to transport passengers, cargo and mail within another State between the airports of that State. (Cabotage) This freedom is rarely granted.

The first two freedoms are "technical freedoms", while the following are "commercial freedoms". A ninth freedom to mention is the right to interrupt a flight.

The Chicago Convention was developed in close connection to IATA, which has been a vital actor in developing a legal framework for the international transportation, including the above-mentioned convention. Historically, IATA was primarily promoting safe, regular and economical air transport for the benefit of the peoples of world, fostering air commerce, studying connected problems, providing means for collaboration among the air transport enterprises, and cooperating with ICAO (International Civil Aviation Organization - the specialized United Nations agency for civil aviation). Further legal developments include the modernization of the Warsaw Convention – on the liability for passenger injury or death and cargo damage or loss, not yet finalized; the Bermuda Agreement – a bilateral air transport agreement between the US and the UK, one of the first almost 4,000 bilateral air transport agreements so far signed and registered with ICAO; and a line of Traffic Conferences for the purpose of overseeing prices charged by international airlines. The Traffic Conference has been central in reaching nearly 400 resolutions covering all aspects of air travel. These include the multilateral interline traffic agreements, the passenger and cargo services conference resolutions, passenger and cargo agency agreements and sales agency rules. The European Union nations accord IATA Tariff Conference a block exemption from the provisions of community competition law[33]. All the same IATA's importance in legislating on air transport within the European Community has gradually decreased as community legislation on air transport has developed.

4.2 Protection Against Domestic Competitors

Protection of scheduled air services has been achieved by shielding these from charter airlines. National governments have separated the two through civil aviation law by protecting national flag carriers, which are usually scheduled airlines, against charter airlines and other scheduled airlines. In order to compensate for a statutory obligation to operate services, tariffs, among other things, are subject to approval. Since the regulatory system generally prevent the sale of tickets at prices below the approved tariffs, national carriers for a long time never had to face serious competition. They did not have to fear foreign competition of scheduled traffic due to bilateral air service agreements which, divided capacity between the national flag carriers concerned equally. These permitted only the national carriers to operate some services.

4.3 Limited Competition

A number of the bilateral air service agreements concluded among the members of the EEC contained provisions for multiple designation, and thereby limited the possibility of competition. Capacity fixing provisions of some of these agreements enabled the airlines to fix capacity shares according to expected demand, with controls only introduced afterwards.
As can be seen, the Community air transport market has been one of the most regulated markets for a long time and has had high national barriers. In the Treaty of Rome (1957) it was only mentioned in Article 84(2), where it was excluded from the other transport policy. Air transport policy measures were to be taken upon decisions made by the Council. Some attempts towards liberalization were taken, such as the first memorandum publicized by the Commission in 1979[34], and the Council Directive liberalizing scheduled inter-regional services to some extent[35] (among other directives), but without any real practical effects[36].
In the mid 1980's changes started to take place. There are three major reasons for this[37]: the deregulation of domestic air transport in the United States with effect from 1978, which affected the structure of the US industry and its competitiveness with other airlines and also influenced the general worldwide climate of opinion; the decision of the European Court of Justice in the "Nouvelles Fronieres" case[38], which confirmed that the Treaty's competition rules applied to air transport; and the conclusion if the Single European Act in 1986, which made the change from unanimity voting by qualified majority in respect of most air transport policy legislation and completion of the internal market.
An internal market for the community air transport was to be achieved through two means. First of all, through policy legislation under Article 84(2), aimed at Member States by gradually breaking down restrictions on competition between airlines of different States and by abolishing

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[33] IATA, "50 Dynamic Years. A brief history of the International Air Transportation Association".
[34] Memorandum, Contribution of the European Communities to the development of a Community air transport policy, EC Bulletin Supplement 5/79
[35] Council Directive (EEC) 83/416 (O.J. 1983, L 237/19)
[36] CML Review 1994, John Balfour, "Air Transport – A Community Success Story", p. 1026
[37] see note 2
[38] Joined Cases 209-213/84, Ministre Public v. Lucas Asjes and others, (1986) ECR 1425; (1986) 3 CMLR 173

national barriers and move from a bilateral to a multilateral system. In addition, competition rules should be applied in order to eliminate anti-competitive arrangements between airlines.
Following a brief description of the historical development of the policy legislation will be given, emphasizing its current status, continued by an exposition of the competition rules related to the community air transportation sector.

4.4 Liberalization

By the end of 1987, a first package of liberalization measures were adopted[39], which would allow for a phased approach to liberalization. The European Parliament made an evaluation of the effects of the first package.[40] In view of this evaluation, Visser came to the conclusion that the first package had only brought small change, and that only a change in the minds of the national authorities and the national carriers can promise a better result for the second package. He went on by stating that only a further, well graduated and balances, liberalization of competition could lead to progress toward a liberal common transport market and that a requisite for this was the adoption of a set of specific supporting measures. Various forecasts expected a rapid development of air traffic and passenger demand within the years to some. This development seen in relation to, for example, the seriously congested airports in Europe and inadequate air traffic control, called for supporting measures. A sound development of air transport in a liberalized market would require not only a solution to the problems mentioned above, but also supporting social and technical measures, according to the European Parliament.
In 1990, a second package was adopted by the Council, which was a considerable alteration of proposals presented by the Commission. It built on the first one, by a modest extension.[41] The third package was a great leap forward, including three regulations.[42] It removed most barriers to an internal community air transportation market and introduced new rules on airlines licensing.

4.5 Licensing of Air Carriers

The regulation on licensing[43] requires an airline, which is to be licensed, to operate as an airline by a Member State to satisfy certain requirements as to financial fitness, technical fitness and nationality of ownership and control. There has been discussions on the interpretation of the ownership and control requirements enshrined in Article 4(2) of this regulation. The case of Swissair/Sabena[44] clarifies the Commissions interpretation of those requirements. Firstly, Article 4(2) is essentially designed to safeguard the interests of the Community's air transport industry, and to ensure that market access is effectively exploited by Community air carriers, and not third country carriers. Secondly, 50% plus one share of the equity capital of the air carrier should be held by Member State and/or nationals of Member States. Lastly, the effective control requirement is complied with if the ownership requirement, described above is fulfilled so that this leads to and ultimate decision making power in the management of the air carrier concerned. Consequently, any airline that fulfills these requirements will be granted an operating license, which allows it to operate to almost any destination within the Community. Moreover, the Commission has stressed that the authorization of leasing arrangements by the national licensing authorities is required exclusively for "the purposes of ensuring safety and liability standards". Nevertheless, the national licensing authorities have certain leeway in applying the regulation, which might lead to diverging national practices, and ultimately possible distortions of

[39] Council Directive (EEC) 87/601, Council Decision (EEC) 87/602 (O.J. 1987, L 374/12), Regulation (EEC) 3975/87 (O.J. 1987, L 374/1) and Regulation (EEC) 3976/87 (O.J. 1987, L 374/9).
[40] Visser-Report, DOC-DE/RR/83827 PE 136.055/final, p. 29 et seq.
[41] Council Regulation (EEC) 2342/90 and Council Regulation (EEC) 2343/90 (O.J. 1990, 1,217/1)
[42] Council Regulations (EEC) 2407/92, 2408/92 and 2409/92 (O.J. 1992, L 240/1)
[43] Council Regulation (EEC) 2407/92 (O.J. 1992, L 240/1)
[44] Commission Decision (EC) 404/95 (O.J. 1995, L 239/19)

competition within the common market[45]. Therefore, the Council has called upon the Commission to examine the application of the rules as to ensure their uniform enforcement by all Member States.[46]

4.6 Access to Routes

The regulation on access[47] requires Member States to allow any licensed Community carrier to operate between and two points within the community, subject only to limited exemptions. This regulation provides for a progressive implementation of market access rights along the following timetable: a) as of January 1996, access to domestic routes was partly restricted by allowing Member States to maintain exclusive concessions, which were granted prior to the entry into force of the first package on routes, where other forms of transport could not ensure an adequate and uninterrupted service; c) until April 1997, access to domestic routes can be restricted for air carriers licensed in the respective Member State; d) cabotage operations are still limited to a certain extent, but the limitations will expire in March 1997, completing the liberalization process.

4.7 Fares and Rates for Air Services

The regulation on fares[48] removes all restrictions on Community air carriers from charging what fares they wish on intra-Community air routes. The same principle applies to charter fares to be paid by the passengers for carriage on non-scheduled services. Member States cannot require prior authorization of fares, more than 24 hours before they become effective. The regulation contains safeguard clauses that, under certain conditions, allow for intervention by Member States and the Commission in view of withdrawing excessively high basic fares or stopping further fare decrease in cases of sustained downward developments of air fares (downward spiral).

4.8 Slots

Most of the regulation of slots has been handled by IATA in meetings coordinated by them. There, the airlines regulate themselves in accordance with certain principles and guidelines set up by IATA. "Grandfather rights", giving an airline the right to use a lot at an airport in one traffic season the next corresponding season, is one of the regulations developed. The Commission has taken some legislative action in this area, leading up to Council Regulation 95/93[49]. The Regulation contains rules on schedule coordination and allocation of slots at Community airports, particularly in the case of congestion. The rules specify the responsibilities of national authorities and airport "coordinators", prescribe the process to be followed for the allocation of slots, guarantee "grandfather rights" subject to "use it or lose it" requirements, and create special rights for "new entrants" and possibilities to reserve slots form certain domestic scheduled services. This regulation was revised in July 1997, whereby the Commission has issued a discussion paper setting out proposals for amending the rules where deficiencies have been identified[50]: a) procedural and institutional rules form amending the rules relating to the conditions of airport coordination; b) treatment of new entrants, the use-it-or-lose-it principle, and exchange or transfer of slots; c) introduction of market mechanisms and/or administrative

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[45] Niejahr, M., "The next implementation round. Presentation to the 1996 European Air Transport Conference, Brussels – 22 April 1996". European Commission. Directorate General for Transport.
[46] O.J. 1995, C 169/3
[47] Council Regulation (EEC) 2408/92 (O.J. 1992, L 240/8).
[48] Council Regulation (EEC) 2409/92 (O.J. 1992, L 240/15)
[49] (O.J. 1993, L 141/1)
[50] see note 4

measures limiting the scope of the grandfather rights, making a minimum number of slots available.

4.9 Computer Reservation Systems

Community rules on computerized reservation systems (CRSs) are found in Council Regulation (EEC) 2299/89[51], which were revised by the end of 1997. The Commission has issued a discussion paper, proposing the following revisions: a) the rules should be extended to include rail options (where they compete with air transport services) and subscribers (in order to improve the service for the customers and protect the air carriers from the effects of possible abusive bookings by subscribers); b) requiring the fares charged to subscribers to be non-discriminatory, reasonably structured and reasonably related to the cost of the service provided and used; c) exclude any preferential treatment of code-share flights by requiring the CRS display to show such flight only once[52].

4.10 Groundhandling

In March 1996, the Council adopted its common position on the draft groundhandling directive. It states that the groundhandling market shall be progressively liberalized, in function of size of the airport and the type of groundhandling services concerned, between January 1998 and January 2001[53].

4.11 Airport Charges

The Commission is drafting a proposal for a legislative measure, directive or regulation, on airport charges, tabled in the summer of 1996. It will mainly regard two areas: 1) the obligation for airport charges to comply with the principles of non-discrimination, cost-relatedness and transparency; 2) the possibility for airport charges to be modulated in function of slot availability and environmental concerns.

4.12Passenger Protection

Council Regulation (EEC) 295/91[54] establishes common rules for a denied-boarding compensation system in scheduled air transport, designed to ensure a speedy and effective minimum protection of the passenger in case of denied boarding. The Commission has received several complaints from individuals and consumer organizations as they believe that the air carriers do not respect the obligations to apply the rules, but has to confine to persuasion and refer any complaining passenger to the national courts. This deficiency is to be examined by the Commission[55].

4.13 The Competition Rules

There is a set of competition rules that have developed through Commission proposals, Council Regulations, and ECJ rulings. These should be examined before looking at how they have been applied by the Commission in specific cases.

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[51] O.J 1989, L 220/1
[52] see note 4
[53] see note 4
[54] O.J. 1991, L 36/5
[55] see note 4

Initially, competition rules did not apply to air transport, even though a proposal was put forward by the Commission in 1979[56], which was amended through the years. When the ECJ took a decision on the so-called Nouvelles Frontieres case[57], competition rules were finally applicable on air transport.

4.14 Nouvelles Frontieres

It was now confirmed that competition rules applied to air transport even in the absence of an implementing regulation. Both the Commission and the competition authorities of the Member States could now enforce the competition rules. Nevertheless, neither of these institutions could issue block exemptions. The Commission set up proposals that were adopted in December 1987, which were a part of the first package as Council Regulations (EEC) 3975/87 and 3976/87[58]. These implemented Articles 85 and 86 EC with regard to international air transport between Member States, and the Regulation 17[59] empowered the Commission to grant block exemptions from Article 85 (1) EC for certain kinds of agreements, decisions and concerted practices. Further block exemptions regarded capacity planning, revenue sharing, tariff consultation, slot allocation, computer reservation systems and ground handling services[60].

4.15 Concentrations

There are two Council Regulations, (EEC) 4069/89[61] and (EEC) 4064/89[62], on the control of concentrations between undertakings, which is used parallel to Articles 85 and 86 or the Treaty.

4.16 Ahmed Saeed

When the ECJ delivered a judgment on the “Ahmed Saeed” case[63] it was established that the competition rules also applied to air transport between Member States and non-Member States. Until now, the first package had only covered transport between Member States.

4.17 The Second Package

The adoption of the second package in 1990 entailed only a few amendments. Basically, there was an extension of the block exemptions to add consultations on cargo rates as category of agreement eligible for block exemptions, and an extension of the validity of block exemptions until 31 December 1992[64]. In addition, three new block exemptions, with slight modifications, were introduced to replace those that expired on 31 January 1991[65]. Moreover, the Council adopted a regulation that would provide the Commission with interim measures against anti-competitive practices in relation to the air transport sector[66].

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[56] The First Memorandum, Contribution of the European Communities to the Development of Air Transport Services (Supplement 5/79 – Bull. EC.).
[57] see note 4
[58] O.J. 1987, L 374/1
[59] Council Regulation (EEC) 17/32 (O.J. 1962, 13).
[60] Commission Regulations (EEC) 2671/88, 2672/88 and 2673/88 (O.J. 1998, L 239/9).
[61] O.J. 1990, L. 257/13
[62] O.J. 1989, L 395/1, also called Merger Regulation. See also Commission Regulation (EC) 3384/94 on the notifications, time limits and hearings provided for in Council Regulation (EEC) 4064/89 (O.J. 1994, L 377/1).
[63] In case 66/86, Ahmed Saeed Flugreisen and Silverline Reiseburo v. Sbu W, (1989) ECR 803; (1990) 4 CMLR 102.
[64] Council Regulation (EEC) 2344/90, 83/91 (O.J. 1990, L 217/15).
[65] Council Regulations (EEC) 82/91, 83/91 and 84/91 (O.J. 1991, L 10/7).
[66] Council Regulation (EEC) 1284/91 (O.J. 1991, L 122/2).

4.18 The Third Package

At its adoption in August 1992, two regulations related to competition rules were installed. One extended the scope of the existing implementing regulation to domestic air transport within a Member State[67]. The other one extended the scope of the existing regulation authorizing to issue block exemptions, made changes to the categories of agreement eligible for exemption, and extended the period of validity of any block exemptions adopted beyond the end of 1992[68]. All the same, new block exemptions were not issued for some time. The exemption for ground services expired in 1992 without a replacement. The two other block exemptions were extended beyond 31 December 1992. Eventually, they were replaces, so that new regulations issued by the Council on slot allocation and CRS could be taken into account. Both of these were replaces after a while[69].

4.19 Application of the Competition Rules

The results and implications of the legislation on air transport competition rules becomes clearer by looking at how these have been enforced. Below follows a brief exposition of what has happened in relation to the competition rules for air transport.

4.20 Article 85

This article falls under the section on rules on competition applying to undertakings, and particularly two or more undertakings restricting or distorting competition. The Commission has not enforced Article 85 on its own initiative. There have been some examinations of applications for joint operations between airlines, where both exemptions have been granted and termination required. IATA resolutions have been examined, and later modified or withdrawn.

4.21 Article 86

This article falls under the same section as Article 85, but concerns the abuse of a dominant position of one company. Article 86 has been enforced by the Commission several times, particularly in relation to refusals to interline[70]. Lufthansa had to reinstate their interlining authority for Air Europe on the London-Munich route in 1990[71], as did Air Lingus for British Midland on the London-Dublin route[72]. Article 86 was also applied on a refusal by Sabena to allow access to its CRS to London European[73]. The proceedings were taken under the general regulation implementing the competition rules, rather than the specific regulation for air transport, as it was not directly a case falling under air transport as such.

4.22 Concentrations

The Commission has actively monitored concentrations between airlines, exemplified by many cases. Article 85 and 86 were used on the cases of British Airways acquiring British Caledonian[74], Air France acquiring UTA[75], and increased shareholding by KLM in Transavia[76].

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[67] Council Regulation (EEC) 2410/92 (O.J. 1992, L 240.18).
[68] Council Regulation (EEC) 2411/92 (O.J. 1992, L 240/19).
[69] By Commission Regulations (EEC) 161/93 (O.J. 1993, L 155/18) and 3652/92 (O.J. 1993, L 333/37).
[70] The practice whereby one airline is prepared to accept the tickets of another for carriage on its own services and also to accept joint tickets for services one of which is provided by itself and one of which is provided by another airline.
[71] See Commission press release IP(90) 384.
[72] (O.J. 1992, L 96/34).
[73] (1989) 4 CMLR 662
[74] (1988) 4 CMLR 258

All these were solved by "settlements" between the parties and the Commission, whereby the acquisition could proceed in return for undertakings and conditions designed to preserve and foster competition. Examples of these settlements are British Airways giving up slots at Gatwick to make way for new entrants, and Air France divesting its shareholding in the French regional airline TAT.
As the Merger Regulation came into force, Articles 85 and 86 were applied on concentrations. Since then, four cases of concentrations have been examined by the Commission. The First, Delta/Pan Am case[77], was subject to the scope of the Merger Regulation, although the two airlines did not originate in the EC, as the Community wide turnover exceeded the limit. Their concentration was not seen as negatively affecting competition, due to the highly competitive nature of the transatlantic air service market. In the second, Air France/Sabena concentration[78], the proximity of the Paris and Brussels airports made the Commission divide the routes on which the two airlines competed into three different categories, in order to secure that competition prevailed on these routes. In the third, British Airways/TAT case[79], the Commission reached a similar decision. The fourth, British Airways/Dan Air case[80], concerned the specific effects of the concentration on the Belgian market. The Commission came to the conclusion that the effects were limited due to the highly competitive nature of the London-Brussels market.
In 1994, the Commission was asked by the Comite des Sages, also called the "Committee of Wise Men for Air Transport", to look favorably upon mergers and alliances as a useful vehicle for the restructuring of the industry in the report "Expanding Horizons"[81], presented on 7 February 1994, during a Council meeting in Athens. They asked the Commission to object to such arrangements if they created a dominant position or resulted in an insufficient number of competitors of the community. The Commission acknowledged the need for such restructuring[82]. Their view was shown when they granted the alliances between Swissair and Sabena[83] and Lufthansa and SAS[84]. The Commission considered it to be important that the alliances would improve their ability to compete globally. This ground constituted a reason for the approval and exemption under Council Regulation (EEC) 4064/89 and Article 85(3) of the Treaty. To ensure that effective competition was upheld in the Community air transport sector, the Commission set up a number of conditions: a) frequencies offered by the partners could be limited in case of new entry of a competitor, b) competitors should be able to interline with and participate in the frequent flyer programs of the partners; c) slots should be made available to competitors; d) the partners are obliged to denounce any cooperation agreements with other carriers pertaining to those markets; e) regulatory barriers to entry in bilateral air service agreements in those markets should be eliminated (applicable only in the Swissair/Sabena case).

4.23 Article 90

This article falls under rules on Competition, applying to public undertakings and undertakings to which Member State grant special or exclusive rights. Many airlines are characterized in this way, why the Commission has had reason to apply the Article in some instances, although only a few[85].

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[75] see Commission press release IP (90) 870
[76] see Commission press release IP (90) 658
[77] see Commission press release IP (91) 828
[78] see Commission press release IP (92) 792
[79] see Commission press release IP (92) 978
[80] O.J. 1992, C 328/4 and O.J. 1993, C 68/5
[81] The report constitutes an action program for the future of the European Aviation Industry
[82] See "the way forward for Civil Aviation in Europe", COM (94) 218 final, 1.6.1994, p.12
[83] Commission Decision of 19 July 1995 in Case IV/M. 616
[84] Commission Decision 96/180/EC of 16 January, 1996, O.J. 1996, L 54/28
[85] Re Transport to the Canary and Balearic Islands, (1988) 1 CMLR 331, Commission press releases IP (90) 730 and IP (91) 494, O.J. 1990, L 10/47 and O.J. 1990, L 233/19

4.24 State Aids

Rules on state aids are found in Articles 92 and 94 EC, and guidelines on their application are found in the Commission's second memorandum from 1984[86] and the Nouvelles Frontieres decision 1986. Not until 1991 did the Commission initiate its first major investigation after having approved Belgian State aid to Sabena. This would be a part of a restructuring package and the aid would be the last[87]. In 1991 and 1992, the Commission examined two cases of injection of state funds into Air France. In both cases the Commission found that the injections did not constitute state aid, but rather that into Air France seemed to provide a good investment opportunity. Formal decisions were never taken, but only brief press releases describing the reasons for its conclusion[88]. In the Iberia case[89] the commission found that the airline was receiving State aid, similar to the Sabena case. No formal decision was issued.

Since 1993, the Commission's attitude on state aids has hardened, as can be seen from some cases. The first major case illustrating this attitude involves state aid tp Aer Lingus, where the airline was required to constrain its routes between Dublin and London, as British Midland had argued that it constituted unfair competition[90]. The Commission has also examined capital injections into TAP[91] in the context of a restructuring plan as well as a third and fourth capital injection to Air France, and capital injections into Olympic[92].

Basically, authorizations of state aid injections have been granted based on presentations of comprehensive and self-contained restructuring programs, designed to restore the carrier's financial health within a reasonable time period implying that further aid will not be granted in the future. The Commission has imposed numerous conditions on the national authorities and the air carriers to ensure that competition is not affected, increasing from five in the Sabena case to 21 in the Olympic Airways case.

Furthermore the Commission made a commitment in 1994 in its guidelines on the application of Articles 92 and 93 of the Treaty and Article 61 of the EEA Agreements to state aids in the aviation sector[93], not to allow any further restructuring aids, unless it is a justified by exceptional circumstances, unforeseeable and external to the company (the one-time-last-time principle). Still, a Member State can inject capital into an air carrier it owns, as private and public undertakings shall be treated in exactly the same way[94]. According to case law of the ECJ[95], the market economy investor principle can be applied by the Commission for determining whether or not a capital injection should be scrutinized or not. Consequently, capital injections into state-owned carriers are only subject to the one-time-last-time principle of the market economy investor principle demonstrates that it constitutes state aid.

The market economy investor principle has been used twice so far. In the Iberia case it was concluded that it was not a question of state aid, although the Spanish authorities made a second capital injection. The Commission approved the plan 31 January 1996, due to changed circumstances and a number of commitments made by the Spanish authorities. There are three further precedents of May, July and October 1995 involving, respectively, Lufthansa, Sabena, and the French air carrier AOM. The Sabena precedent shows the determination of the Commission to: 1) adhere to the one-time-last principle; 2) treat privately and publicly owned air

[86] "progress towards the development of a Community Air Transport Policy" (COM(84)72)
[87] Commission Decision (EEC) 91/555 (O.J. 1991, L 300/48)
[88] see Commission press releases IP (91) 1024 and IP (92) 587
[89] see Commission press release IP (92) 606
[90] Commission Decision (EC) 94/118, 1993 (O.J. 1994, L 54/30)
[91] Commission Decision (EC) 94/698, 1994 (O.J. 1994, L 254/73)
[92] Commission Decision (EC) 94/696, 1994 (O.J. 1994, L 273/22)
[93] O.J. 1994, C 350/5
[94] Article 222 of the EC Treaty
[95] judgment of the court of March 13 1985, Joined cases 296/82 and 318/82, Kingdom of the Netherlands and Leeuwarder Papierwarenfabriek BV v. Commission of the European Communities, 1985 ECR, P. 809

carriers equally; 3) apply the market economy investor principle primarily to structural, rather than operational conditions.

4.25 External Relations

The internal air transport market has now almost been achieved and hence the Commission is now working more vigorously on enforcement and policing and looking outside the Community borders. Community air transport is inevitably inter-connected with the global air transport system. External aviation is approached in the way of exportation and competence.

4.26 Exportation

Exportation of Community air transport liberalization was initiated the first time by the Commission when this legislation was extended to Norway and Sweden, leading to a Council decision[96], subsequently overtaken by the EEA Agreement, which extends basically all Community legislation to the EFTA countries[97]. As of today, Sweden is currently a member of the EU. The Commission has also discussed with other European States about a possible conclusion of aviation agreements, or more general association agreements.

4.27 Competence

The Commission has issued several communications on the Community competence over external aviation relations. The first communication[98] was based on a decision by the ECJ[99]. In 1992 a second communication was issued[100], where the Commission maintains its views but also sets out some more practical proposals for the future. No decision has been taken in this field yet. The liberalization of the European Air Transport has developed, as shown above, and both incumbent and low cost airlines can enjoy same rights and thus can engage in competition with each other to the same degree, since most of the legal obstacles were removed with liberalization.

[96] Council Decision 92/384, O.J. 1992, L 200/20
[97] in 1996, Norway, Iceland, Switzerland, Finland
[98] COM (90) 17 final
[99] In case 22/70, Re ERTA: EC Commission v. EC Council (1971) ECR 263, (1971) CMLR 335
[100] COM (92) 434 final

5. Airline Industry Analysis According to Porter's Five Forces

In this chapter I will examine Porter's five competitive forces. These forces sometimes represent obstacles for low fare airlines and serve as an advantage for incumbent companies or visa versa. I will examine them from the prospective of both incumbent and low fare airlines, and define which of these five forces represents an advantage and disadvantage to the categories of above-mentioned airline companies. It is important to examine these forces, since they influence the choice of strategy both of new entrants and incumbents to certain extent.

The five competitive forces mentioned by Porter are as follows:

1. The threat of new entrants
2. The threat of substitute products or services
3. The bargaining power of suppliers
4. The bargaining power of buyers
5. The rivalry among existing competitors

5.1 The Threat of New Entrants

When new entrants are threatening to enter the industry they will add capacity and will try to gain market share, which will mean that existing competitors will lose some of their shares. One of the consequences is the decreased margins that limit profit potential of the industry. I would say that is the current situation in European Airlines industry. The same experience was undergone by the USA airline industry in 1978, when after the deregulation new entrants appeared on the market, brought new capacity that was used to gain market share. However, incumbent companies managed to reduce the threat of new entrants through their strategies and control over the important facilities[101]. Entry barriers are similar in European market:

5.1.1 Computer Reservation System (CRS)

CRS is used by travel agents to keep up-to-date with the latest fares and seat availability allowing them to access the data in real time. There are two major reservation systems in Europe: Galileo and Amadeus, which are owned by the incumbent airlines. CRS allows airlines, which have standardized units of capacity, to set fares in relation to demand and helps airlines operate effective market segmentation. CRS is a key marketing weapon for the incumbent airlines. Its vast database makes it possible to access complete flight, hotel and car reservation information. The system provides owning airline not only with the priority to display its services but also information regarding bookings of any other airline using the system. The position of flights displayed on the CRS is important, since it is highly possible that the flights, which show up first on the screen will be booked. Also travel agents are more likely to become familiar with the airline that appears first so when inquiring in the future for a suitable flight they are more likely to book with the airline whose schedule they are acquainted with. CRS gives information necessary for companies to identify customers' requirements in order to make its services more appropriate to their demands. New entrants, which are not able to join the CRS are at disadvantage, since they do not have the same kind of marketing tool. The CRS can influence passengers preferences in favor of an airline. Thus the airlines using CRS establish themselves more easily and not listed airlines have to persuade customers to switch from competitor's services to theirs'. Airline owning CRS is in a position to resist the entry of new airline as CRS allows major airlines to refine fares to a greater extent, thus further disadvantaging the small new entrant. However, Ryanair has a different approach about this issue. They have developed the biggest travel site in UK and consider that using the website they can achieve the desirable

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[101] Jahnson. M., "Removing Barriers to Market Entry in the Air Transport Industry: The application of EC Competition Rules" Legal issues of European Integration. Deventer, 1993, No.2

results, and they do not approve of using travel agents for the sale of their products. According to Howard Miller, CFO of Ryanair: "We want to cut out the middleman. Our business has changed radically over the last 4 years. About 4 years ago, 25% of our sales were direct and about 75% was through travel agents. By the end of this year we'll be doing 70% of our business direct. Well in excess of 25% on the Internet and about 37% over the phone. And then travel agents, as I said, down to 38%."[102] Easy Jet manages ticket sales without involving travel agents. 59% of its sales is done via internet and 41% via call centers.
In addition it is also possible that travel agents look for their higher benefits and this results in higher costs for new entrants in persuading buyers to switch than for incumbents. For example, commission structures offered by airlines are usually non-linearly related to the gross value of sales booked within a given period. Concentration on promotion of the services of the larger carriers, which offer an extensive network is likely to yield a high volume of sales, thus moving the travel agent into a higher commission band. Therefore a travel agent is likely to book a flight with airline, which it already does a lot of business than a less frequently used carrier, where commission rates are likely to be lower[103].

5.1.2 Frequent Flyer Programs (FFP)

FFP are used by airlines to provide rewards to their frequent customers. These awards are reflected in the form of points, which count towards free flights, ticket upgrades, holiday and leisure travel. Advantages of FFP for airlines is that they make it possible to balance loads on flights since they are usually restricted and they are a strong marketing tool for matching customer requirements more exactly and developing new marketing strategies. Bonus points are valuable if consumer flies regularly with the issuing airline. FFP usually aim at full fare-passengers, who quite often do not pay for their tickets themselves and will not hesitate to choose airline on the basis of the FFP benefits. These airlines can then charge higher prices than the market equilibrium without losing customers. This happened in the USA, when 81% of business travelers chose certain flights to accumulate bonus points half the time.[104] Using FFPs with CRSs creates product differentiation and strong brand loyalty with the consumers. At the same time FFPs act as barriers to entry since new entrants will have to offer better bonus programs then existing competitors. In addition, new entrant is likely to have a smaller route network at the beginning and thus there will be fewer opportunities for customer to earn bonus points and therefore they will be less willing to switch to the new entrant. The way out for new entrant is either to establish a route network with considerable size or compensate for the less extensive network by initially awarding a higher level of bonus points, however, this will cause significant opportunity costs.

5.1.3 Reputation

Incumbent airlines have spent much time and funds in establishing their reputation over the years. New entrants will need to make big investments and over a sustainable period of time in order to overcome this barrier. Thus establishment of the image can be very expensive for new entrants. However, most of them do not use any special advertising agency, since the organizations are small and they operate few routes. According to Easyjet's Marketing Manager - Tony Anderson, most of the time he and chairman of the company create advertisements themselves. They believe this way they get quick response, and also know the product better than anyone else. However, this does not change the situation, new entrants still have to spend more on promotion than incumbents, so that potential customers get information about new flight

[102] Keynote Speech. Howard Miller, CFO, Ryanair available at http://www.eyefortravel.com
[103] Furgeson, P.R., & Ferguson, G.J., Rothschild, R., (1993), "Business Economics", Macmillan Press LTD. p. 22-23
[104] refer to note 13

possibilities. According to the figures of the advertisement amounts, Easyjet in 1997 invested in advertisement a little over 3 million pounds. [105] In contrast to incumbents, startups have to advertise constantly since their sales go without travel agents for most part and their products are offered directly to the public.
Another important aspect is that often new entrants and especially low fare airlines have the reputation of being unsafe. However, the safety editor of Flight International – David Learmount argues: “There is a view that if it is cheap it must be rubbish, and that is not true. The European charter industry is the cheapest form of transport in the world – and also the safest – including the US, with more modern fleets than many scheduled carriers”. Moreover, Philip Martin, director of Air Transport Users Committee says: ”passengers should have no concern about safety with no-frills carriers. Low-cost operations are not achieved by cutting safety standards but by reducing distribution costs and not providing passengers with services they do not want to pay for”.[106]

5.1.4 Cost

Operating costs naturally vary according to the type of aircraft. It is very important that the fleet of an airline corresponds to its network. Airlines try to operate aircraft types that are as economical and otherwise possible for the particular routes in their network. The larger the network, the easier it is to find nearly ideal routes for particular aircraft types. On the other hand, smaller airlines usually have to make compromises in matching aircraft with routes.
Incumbent airlines have the advantage of achieving economies of scale or scope, and thus can reduce their costs. New entrants do not have the same possibilities, and thus the cost difference might serve as a barrier to entry. Economies can be achieved by major airlines through technology, labor and maintenance facilities. Since there are high fixed costs in the airlines industry it is of great importance that airlines operate in the most efficient manner to cut costs wherever possible. Differences in costs can be found due to the utilization of aircraft and scheduling, and variations in labor reimbursement. Otherwise airlines operating on the same route mostly have the same costs since aircraft’s, slot prices and check-in facilities are the same.
Cost structure for new entrants are different, they can not take advantage of economies of scale and scope to the same extent as incumbents, however they have other means for lowering costs. For instance, Ryanair and Easy Jet managed to organize their activities appropriately to the market situation. “The evidence suggests that low-cost no frills operations can achieve unit costs as low as half those of a major network carrier”[107] From the quote above it is evident that the characteristic of all low cost carriers is that they operate with much lower costs than the big flag carriers. Appendix 2 shows some of the factors that will make Easy Jet capable of maintaining a lower cost structure than the big flag carriers. It is evident, which areas make flag carriers have substantial higher costs than low cost carriers. Incumbent airlines are hindered by the legacy of high salaries, leases on particular aircraft and established work practices. Even though this approach did not suit the prevailing market condition, it could not be changed quickly because of the airlines’ contractual obligations.
The advancement in information technology that has taken place over the last two decades has contributed to better financial coordination and improved communication within and outside environment of companies a great deal. The result of this is reduction in costs. The emergence of computer programs used for price mechanism tools has allowed airlines to maximize revenues by predicting demand at various price levels. Due to the complexity and nature of price allocation and discounting, computers provide a more effective and efficient means to set fares in relation to demand. Since an airline seat is an important product, when departure approaches carriers prefer to get much less and still fill the seat that will remain empty. Because of the high

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[105] Lennane, A., “Speaking for themselves”, Airfinance, March, 1998
[106] see note 30
[107] CAP 685. Single European Aviation Market: The first five years (June 1998)

operational gearing of the industry and its marginal profitability, even a few extra passengers at a heavily discounted fare can push a particular flight from loss to profit. [108] However, airlines do not want to discount ticket too soon since there are always passengers who are ready to pay full fare. This means that an airline will keep some seats. Thus carriers deliberately overbook flights and hope not to have to pay out compensation to anyone they have to "bump" from over-full flights. From the airlines prospective the main advantage is in the opportunities created for market segmentation together with a yield management link, which ensures that aircraft flies as full as possible at the highest possible fares. One example of such a system is revenue management systems (RMS). In effect, another computer, which is not shared by rivals. The RMS makes checks with the CRS regularly, to see how flights are filling up. The role of RMS is to calculate how to pitch the fares, allowing airlines to take greater advantage of the market segmentation by increasing the number of fare types in order to exploit different price elasticity of demand between passengers. This opportunity gives airlines using CRS competitive advantage over those not using it for example Easy Jet. At the same time Easy Jet avoids paying for the system and travel agents commission. RMS also allows incumbents to take the advantage of economies of density since the number of passengers traveling on a given sector grows, the costs per mile will decrease. The airline might be able to take advantage of larger aircraft. Capacity costs do not rise proportionally with aircraft size. Not only are there economies of increased dimensions, but some costs such as for example, equipment, crew might be largely invariant with respect to aircraft size. Moreover, the fixed costs will be spread over more passengers at each terminal and the airline can benefit from massed reserves and any economies of scale in servicing aircraft. However, Johnson[109] noted that the economies on a single sector are limitless. According to him there are two factors, which are likely to impose ultimate constraints on cost reduction: congestion and the strains on the structural integrity of ever larger aircraft. Incumbents also possess advantage over new entrant by operating hub-and-spoke networks. This option allows them to achieve economies of density by utilizing a given network more intensively.

5.1.5 Price

Pricing is a very complex issue since there might be tens of different prices for basically identical product. Pricing is driven by profitability objective. Even though air transport pricing must relate to a carrier's total cost level, it should also be demand driven, in order to facilitate covering the high share of fixed costs in airline operations.

There are two main categories of passenger fares on scheduled services: normal and special fares. Normal fares are those available to the public without limitations as to their purchase or use. Special fares are lower than normal fares and generally designed to generate revenue by attracting passengers who would not travel at the normal fares. Fares are affected by the competitive situation on each route. Low fares of competing carriers may force an airline to lower its fares. However, often those too cheap fares are cross-route subsidized, meaning that airline charges excessively high fares on those routes where the competitive situation allows it.

According to Munro's[110] definition, price is the only element of marketing mix, which produces revenue instead of costs and has direct effect on profit. Pricing is a complex issue, one that is determined by a variety of factors such as labor costs, price sensitivity and competitive pressures. The competitive situation in the industry, which is split between monopolistic

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[108] According to Furgeson (1993) cost of an extra passenger mainly comprises the commission paid to the travel agency, refreshment cost, incremental cost and minor increase in fuel costs, which in total are unlikely to go over 20% of the ticket price. As long as seat can be filled at a price above marginal cost, profits are increased in the short run.

[109] Johnson, P., (1993), European Industries: Structure, Conduct and Performance", Edward Elgar p. 30

[110] Munro, K., (1990), "Pricing :Making profitable decisions", McGraw-Hill p. 22

competition and oligopolistic market, has effect on pricing. According to Nagle[111] oligopolistic market can be characterized by few sellers in which price decisions are independent. This type of competition prevails on routes where there are few competitors, which results in tactics of one firm having an effect on its rivals. In the airline industry, the largest markets typically include no more than two or three rivals selling largely undifferentiated product. For instance, European routes normally are served by the two flag carriers of each country, until a third carrier shows up and brings down fares due to competition. BA's economy fare, which cost 215 pounds was reduced to 69 for the London Paris route in face of threat from Eurostar trains[112]. According to Sawers[113] the lack of competition on European routes has caused high fares. He shows that in 1983 the average fare per passenger mile, even allowing for variations in input prices, was nearly double that for comparable routes in the USA. He also argues that the availability of discount fares is more restricted in Europe. However, in the current situation price serves as a tool for attracting buyers. And for low fare airlines price can be considered to be the most important factor in differentiating a service and attracting customers from rival airlines. However, low cost airlines do not have the same strategy of selling seats. Easyjet normally exchanges only 10 chairs to the lowest price where after prices rise little by little. As for Ryanair and GO they exchange 50% of their capacity to the lowest price and 20% to the second highest and so on.

5.1.6 Government Ownership and Subsidies

Historically most of the national airlines have been receiving capital injections from their governments. Thus privately owned new entrants will experience a competitive disadvantage and government policy based barrier to entry. At the same time, government ownership of the incumbents can make them less prone to achieve and sustain efficiency, giving the new entrants an advantage in valuing and developing efficiency independent of intrusion by incumbents. Another barrier to entry deals with the government subsidies allocated to these incumbents, which further distort competition. Community legislation has begun to restrict the state subsidies, justified only on certain conditions – the one-and-last-principle; and the fulfillment of the market economy investor principle on primarily structural conditions. These conditions should serve for the purpose of equal treatment of both privately and publicly owned carriers, and reduce entry barrier.

5.1.7 Congested Airports

European airports are quite congested and they are facing an increase in demand far in excess of capacity-expansion plans in place. Slots are very highly valued and the airlines owning them will not give them up easily. National "flag carriers" usually have the largest number of slots at their national airport and usually at hubs, which are important for long haul flights. Lufthansa is holding 50% of the slots at Frankfurt airport and BA 38% at Heathrow airport.[114] Access to slots is very important determinant of the success for a new entrant. In this regard, European Commission discusses the possibilities for limited public auction of airline slots. The plan would end the practice whereby big airlines exchange redundant slots with each other, which makes it more difficult for new entrants to enter the market. [115]

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[111] Nagle, T., (1989) "The strategy and tactics of pricing", Prentice-Hall p. 34
[112] Ramesh, R., (1996), "Fare war brings cheaper flights", The Sunday times, May 5
[113] Sawers, D., (1987), "Competition in the Air", The Institute of Economic Affairs Research Monograph 41, London: Institute of Economic Affairs p. 50-51

[114] Seristo, H., (1993), "Airline Strategies: Deregulation of the European Airline Industry", HSE Press, Helsinki p. 28
[115] Carton, M., "Brussels in Debate over airport slots", The Financial Times July 7, 2000

5.1.8 Concentrations

An increasing number of incumbent airlines are forming alliances and thus create large global networks. They benefit from the economies of scale and scope in various functions of their operations, and achieve synergy effects. CRSs, FFPs, offered frequencies, access to slots, groundhandling and access to route can serve as examples. The commission has authority to monitor and regulate the air transport market in favor of ensuring effective competition, although they are showing somewhat positive view towards some of the alliances notified. They will ensure the contestability of the market and openness to new entrants by inserting conditions on the alliances: limitation of the frequencies to be offered by the partners in the markets in case of new entry of a competitor; possibilities to participate in FFPs; make slots available at their main airports; denounce further cooperation with other carriers in those markets; and eliminating barriers to entry enshrined in any bilateral air service agreements applicable to those markets[116]. The barriers of entry then are found in different areas, which were discussed before but their effects are enhanced by the increased market share of the allied airlines and consequential increase of concentration of the market. Thus the threat of new entrants will be reduced, unless they decide to ally with one of the existing competitors.

Thus even though there are steps taken in the direction of placing new entrants on the same footing as incumbents still as we saw above the barriers to entry exist.

5.2 The Threat of Substitute Products or Services

The threat of substitute is faced both by incumbent and low cost airlines. Since incumbent airlines mostly target business travelers, for who frequency of departures, a good network of destinations and punctuality are of main concern the longer the travel distance the less substitutes can be found. However, as the travel route decreases the availability of other means of service and thus the threat of substitute services rises. One disadvantage of airlines on short routes compared to other means of transportation is that usually airports are located outside cities and there are few of them. Also sparsely populated areas are not served as they are not profitable routes. If they are served the frequency of flights is usually low[117]. This means that passengers begin their journey by traveling to airports and after the flight from the airport to the final destination.

As for the low cost airlines they consider that there is a bigger threat for them are alternatives such as bus and rail and not their larger counterparts. For example, Lockwook[118] believes that the growth in traffic for low-cost carriers “is passengers enticed away from road and rail alternatives”. According to Managing Director of Easy Jet – Ray Webster: “We feel certain we are attracting traffic, which would not otherwise have flown”.

One of the substitute of air service is high speed train, which can provide a speedier alternative to making short journeys by air. Eurostar is one of the serious threats of substitute services. It operates between London’s Waterloo station and Paris and Brussels. This rail links are faster and often less expensive alternative to air travel, offering customers higher value for money. If we take time and price into consideration: instead of having to make the journey out to an airport, allowing an hour to check in, undertaking the air journey and transferring from the airport to the city at the other end, people will be able to travel directly from one city to another, in a single leap by Eurostar. Mr. Richard Hannu, transport analyst at UBS, believes that it would be a mistake to write off the airlines too soon. He points that people’s decisions about whether to use

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[116] Niejahr, M., “The next implementation round. Presentation to the 1996 European Air Transport Conference, Brussels – 22 April 1996”. European Commission. Directorate General for Transport.

[117] Seristo, H., (1993), “Airline Strategies: Deregulation of the European Airline Industry”, HSE Press, Helsinki p. 102

[118] Lockwood, C., (1998), “Cheap and Cheerful”, Executive traveler, December/January

train or aircraft on a journey from London to Paris will depend very much on where their journey starts from. According to Mr. Hannu "Clearly the train is quicker from city center to city center, but in real life that is not necessarily where people's journey's begin and end. If everyone started their journeys from Trafalgar Square, for example then the train would be faster. But if you are a businessman setting off in the morning from your home in the Surrey or Hertfordshire commuter belt, the idea of traveling into London to take a train might be less attractive than driving to Gatwick or Heathrow."[119]

Eurostar has seen an increase from 30,800 to 529,000 in the number of passengers using these services in July 1994, which has been partly at the expense of scheduled airlines. Since the introduction of Eurostar service Air France lost 38% of passengers on its London to Brussels route.[120]

As part of a strategy of stepping up the competitive pressure on the airlines', Eurostar has introduced new products. As from October 1996, the former first class services was split into "Business First" and Premium First" aimed at matching the airlines' business class and first class products. Eurostar also has plans to split the former standard class into two, with the introduction of a new "Economy Plus" product.

Even though it is possible that trains will succeed to take away passengers on short distance journeys, airlines can always switch services to the fast-growing inter-continental routes instead. According to Peter White, European Regional Manager at British Airways, that is the advantage airline's will always have over the rail companies. "They cannot move their track, but we can fly somewhere else"[121]. Also the fact that to compete on successful routes the airlines operate on would be very costly for rail companies due to the set up costs – building rail lines, and stations where required.

Also an advantage that incumbents have over substitutes is joining their forces in alliances and thus providing even improved range of services in many regards.

5. 3 The Bargaining Power of Suppliers

The performance and conduct of airlines reflect the condition under which services and goods were purchased by them. Suppliers have the power to affect the profitability of the industry. Even though airline industry is considered to be oligopolistic, it deals with the suppliers who are highly concentrated and sometimes even monopolistic. In the situation when both buyers and sellers are so highly concentrated, the close relationship between the two may lead to a breakdown in any market mechanism for goods allocation or for setting a single price.

5.3.1. Airports

Airports belong to one of the supplier groups. They provide groundhandling services. The largest problem is access to slots. There is a special council regulation dealing with the allocation of slots[122]. Most of the European airports are already very congested and because of that slots have turned into scare resources, and there is a physical lack of them, which is managed by coordinators and authorities. Thus the possibilities for airlines to bargain for slots are extremely limited. And in addition the preference is usually given to national flag carrier when allocating space at the airports.

As for the groundhadling services they are supplied by the major carrier resident in the airport, the airport authority, independent agency, the airline itself or another airline sharing its self-handling facilities. In many European airports airlines do not have a choice of the handling

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[119] see note 118

[120] The Economist, "An oncoming train", October, 1995

[121] Skapinker, M., (1995), "In the Path of a Speeding Train: Europe's Airline's face growing competition from railways", The Financial Times, November 3

[122] Council Regulation 95/93 (O.J.1993 L 141/1)

agents. However, the services provided by different agents are similar and airlines do not have a problem of changing them. On the whole, the bargaining power of suppliers is quite high and airlines are vulnerable to them since they all need this kind of service for their operations. In this regard both low fare and incumbent airlines are placed in the same situation. However, since secondary airports are less congested and there is more availability of slots low fare airlines prefer to base their activities there. In addition fewer large national companies operate their flights from secondary airports and thus low fare airlines have more opportunities to secure slots.

5.3.2 Aircraft

Aircraft producers represent a powerful group of suppliers as well. Producers are quite concentrated, and it seems that they have a relative advantage compared to airlines to bargain for the quality that will be offered and the price of thereof. One reason is that aircraft is indispensable for airline and has to be bought from one of the existing suppliers by all means. The aircraft producing industry is even more congested than airline industry. Before making orders, in-depth decision analysis is unavoidable. The most important factors upon which orders should be based are estimated demand for their service, the age of existing fleet, the environmental regulations.

In buying a new aircraft one carrier may obtain preferential treatment from the manufacturer in price or temporary monopoly in ordering a new model early and thus gain competitive advantage over the rival. This was the case with BA when leasing aircraft for its new low fare airline GO. BA managed to get a 10% discount, which would not have otherwise been available for the smaller rivals[123] . Moreover, because of the high financial requirements only large carriers can afford to invest in new technological improvement, and thus they can keep the advantage until rivals secure competitive equipment.

Thus the aircraft suppliers might be more prone to providing services with the better terms for the incumbent airlines with good image, and this might put at disadvantage low fare airlines operating independently, without any auspices from such powerful company as BA.

5.3.3 Labor

Most of the large European airlines are characterized with high labor costs, which equal around 30% of the total operating costs. Many airlines such as SAS, Olympic Airways, Aer Lingus are implementing restructuring plans, including wage cuts, laying off employees and revising employment contracts. This has lead to worries among the employees and especially among the well-educated pilots. Since the terrorist attacks on New York and Washington in September, major carriers including British Airways, Virgin, US Airways and Continental have all made substantial job cuts, resulting in more than 26,000 redundancies worldwide. As a result the downsized employees turned to low fare airlines for employment opportunities. Easy Jet saw a surge in applications from pilots laid off in the crises engulfing the world's airline industry. According to Claire Castleton, HR director at Easy Jet "We have been contacted by pilots who work for the major carriers that have made job cuts but we are not actively seeking to recruit them".[124] Thus the position of downsized pilots is not very optimistic. Furthermore wage differences exist between the employees working at the major airlines parent and at the lower-cost subsidiaries. Naturally this imbalance creates problems between employees and airlines.

Furthermore, carriers employing union personnel may have to pay higher salaries and may not deploy resources with the same flexibility as other less subject to union presence. Ryanair and Easyjet avoid large-scale unionization, which results in hard-working, flexible non-union staff in far fewer numbers and more productive than other airlines. Consequently, the labor costs of

[123] Lennane, A., (1998) "Speaking for themselves", Airfinance, March
[124] Higginbottom, K., "Pilots Scramble for jobs as airline crises kicks in", People Management, October 11, 2001

these airlines are 40% of those of big carriers[125]. This kind of cost structure, high productivity and relatively high level of monopoly routes have enabled Ryanair to remain most profitable.

5.3.4 Capital

When it comes to raising capital airlines compete with other industries as well as among each other so that the question of relative strength between buyer and seller is less relevant than in the aircraft and labor markets. Nonetheless, since financial institutions base their decision regarding allocating funds on the basis of the sound financial situation within a particular airline, the opportunity gears towards the stronger one in terms of financial resources and not the length of existence and type of operations. Thus low fare airlines, such as Ryanair, which it the only airline with profitable record during the last eleven years should not have problems securing funds in case of necessity.

5.3.5 Fuel

Since fuel is sold in highly competitive markets if one company offers an unfeasible price there would be many other firms willing to supply the goods. Thus both incumbent and low fare airlines are in the same situation. However, Ryanair seems to be particularly cautious about fuel prices. According to Mr. Veltman of Ryanair, "we are fully fuel hedged and we have decided a number of years ago we were not going to take any risk in this element of our business, so we hedge for between 12-18 months ahead. So, we have got our fuel locked in".

Thus we can conclude that the bargaining power of suppliers can work for the benefit of both low fare and incumbent airlines. Locking in fuel prices, keeping good financial record and having structured relationship with employees no doubt serves to the advantage of low fare airlines. The same success can be achieved by incumbents, and moreover taking into account their size and reputation, they can easily gain advantage over low fare airlines when it comes to certain preferences from manufacturers of aircraft and gaining competitive slots at the airports. There is no clear distinction of the advantages and disadvantages of the suppliers for the operations of airlines. I would rather characterize them as somehow balanced.

5.4 The Bargaining Power of Buyers

Bargaining power of buyers has always been an important competitive force, however, with the emergence of low cost airlines this power has increased even more. Buyers mostly are divided into two groups: Business and Leisure Travelers. These two groups are considered to have different needs and therefore the treatment airline companies provide to them differs. The majority of incumbent airlines know that schedules business sector is the most lucrative and thus their attention and resources are focused on serving this group. Regardless of the fact that the number of leisure travelers has increased over a couple of years as illustrated below:

Frequency of flying by UK Domestic Air Travelers (%), 1992 and 1995

Number of separate flights in last 3 years for business	1992	1995
1 to 2	40.2	38.1
3 to 4	19.7	25.9
5 to 6	11.0	10.4

[125] The Economist, (1997), "Business: European Airline's Scan the Arrivals Hall: European flag carriers might be able to ignore low-cost competitors for a while", September 27, Volume 344 p. 15-17

7 or more	29.1	25.6
Total	100.0	100.0
Number of separate flights in last 3 years for leisure		
1 to 2	66.6	67.8
3 to 4	18.4	17.1
5 to 6	7.4	8.0
7 or more	7.6	7.0
Total	100.0	100.0

Source: Target Group Index, BMRB International, 1992/1995/Key Note Calculation, 1995

Business travelers are still more profitable group since they are more likely to give shorter notice for their booking and buy full fare tickets rather than standby or economy tickets. On the contrary leisure travelers are prone to purchasing cheaper advanced booking options. The incumbent large airlines are investing much in planes, schedules and executive lounges in order to differentiate product and attract more business customers by closely meeting their demands, which are shown in the figure below.

Factors influencing Airline Choice for Business Passengers

CRITERIA	IMPORTANCE OUT OF 11
Schedule	8.27
Safety	8.03
Punctuality	7.22
Comfort and Legroom	6.84
Efficient Check-in	6.79
Frequent Flyer Program	6.59
Cabin Staff	6.38
Advance Seat Selection	6.33
Cheapest Available Fare	5.54
Lounge Access	5.45
Onboard Food and Drink	5.28

Source: OAG Business Travel Lifestyle Survey, 1997. Lennane, 1998

The attempt to distract customers to think about fare levels can be exemplified by BA, who re-launched its economy class, which aims to attract more customers. If this works out well then BA will not have to lower fares.

As for low cost airlines they attract more leisure than business travelers, since the former are more price sensitive and look for value for money rather than quality of service. The leisure passenger is usually less concerned about the number of flights to a destination or their timing. This offers cost savings for low fare airlines since they can operate fewer and larger aircraft. On the other hand incumbent airlines attract business travelers who look for flexible, hassle free transport and are not as price sensitive. However, the situation seems to be changing and even business travelers seem to start switching to low fare airlines. Because most of them do not offer different classes of service, low fare can only estimate (on the basis of, say, how far in advance tickets are sold) which of their customers are business travelers. Jeremy de Souza of London travel agency Rosenbluth International says about 15% to 20% of business travelers in Europe are flying on low-cost carriers. "Three years ago, the figure was 4% or 5% at the very most. The

reason it is not greater is that the major corporations often have special deals with the major carriers."[126] Now even companies like Merrill Lynch, one of British Airways' three biggest corporate customers, are recommending that their European employees use a low-cost carrier.[127]
Thus low cost airlines are on their way of winning business travelers as their customers, however, in order for them to increase the percentage of this group among their customers, in my opinion, low fare airlines will have to provide a different package of services, one which generated higher costs than that of leisure travelers. Investments and starting operations from main hubs are very important, since business people place high value on the marginal utility of time and on the flexibility to change travel arrangements with the minimum transaction costs. Offering attractive scheduling of early morning and late evening flights to enable a reasonably full days work to be done without necessitating an overnight stay. This would create morning and evening peaks, which would require additional staff to maintain a given standard of service. Cabin configuration would have to be changed reducing the maximum numbers of passengers because business travelers prefer large seats. Satisfying all of these criteria would be quite costly, however, with the increasing trend of business travelers switching to low cost airlines it seems possible that even slight improvements can make a bigger difference for low cost airlines.

5.5 The Rivalry among Existing Competitors

According to Director of Customer Services at Air UK Ltd., Bob Coleman competition is defined as “any airline flying from Heathrow to where we fly”[128]; meaning that anybody who operates the same route is a competitor. Currently there are quite many competing airlines in the industry having different size. The larger carriers are national “flag carriers” which were subsidized for many years, although the kind of aid is becoming less in frequency and more restricted nowadays.
The present competition on the European market can be seen this way: There are divisions of incumbent airlines. First includes: Lufthansa, British Airways, and Air France; the second is comprised of SAS, KLM, Alitalia, and Iberia.[129] And there are relatively newly emerged low cost carriers, some of which like Ryanair are expanding and putting pressures on the incumbent airlines. The competition within the incumbent airlines when it comes to service they offer is not so different. Primary differentiating tools are networks and FFPs. The alliances, in which European airlines engage themselves widen the network through code sharing[130]. Often these alliances also include cooperation between the FFP of the allied airlines. Even though the networks and FFPs offered by incumbents are impressive, they are becoming usual in the whole range of service provided by the scheduled airlines. Therefore there is a need for finding and sustaining new competitive advantages, which will differentiate competition among airline companies. A sustainable competitive advantage seems to be difficult to attain, as other airlines quickly copy any innovations presented by their competitors. The competition between incumbents is quite intense and in addition other participants also affect the rivalry. For instance, charter airlines are becoming increasingly similar to the scheduled airlines. This trend is enhanced as the Council adopted a regulation on fares that removed all restrictions on Community air carriers from charging any fares they wish on intra-Community air routes, and made it equally applicable to charter and non-scheduled services, as to scheduled airlines.[131] In addition, charter airlines are joining the CRSs owned by scheduled airlines, also initiated by a

[126] Labi, A., (2001), “ Cheap Euro Airfares”, Global Business/Business Travel, November 26
[127] see note 126
[128] Taylor, C., (1994), “The Editor interviews…Bob Coleman, Director of Customer Services, Air UK Ltd.”, Managing Service Quality, Volume 4 Issue 1 p. 26
[129] Seristo, H., (1993), “Airline Strategies: Deregulation of the European Airline Industry”, HSE Press, Helsinki p. 103
[130] refer to 6.3
[131] Council Regulation (EEC) 2409/92 (O.J. 1992, L 240/15)

Council Regulation in 1989.[132] On the other hand, low cost airlines are becoming integral part of the European Airline Industry, and thus put additional pressure on the incumbents. These two actors represent threat for the scheduled short-haul services, for more price-sensitive customers. However, the rivalry still gears towards incumbents as have advantage over low cost airlines since they own slots, at important hubs, which is quite hard for new entrants to acquire. Airlines with a large share of slots are able to maintain their position against potential competitors because an entrant cannot usually obtain the terminal facilities and landing slots to match frequencies offered by the dominant airlines. Airlines', which have developed or inherited a dominant position at a hub airport therefore have some control over the local market for air transport[133]. As a result low cost airlines prefer to use secondary airports, which have available slots and at the same time do not engage in the direct competition with incumbents by operating the same routes.

To conclude the chapter I would say that the most important force, which shaped the strategies of the incumbent airlines was regulated environment. Since for a long time until the deregulation of 1993, governments had great control over the flag carriers, and bilateral agreements guaranteed virtually no competition, that could damage European incumbent carriers, they started to pursue, expensive strategies, which are used to great extent at present as well. The strategies include operations from big centralized airports, building hub-and-spoke networks, participation in CRS, high remuneration of the work force, ticketing services, luxurious lounges for business travelers. As for the strategies of low cost carriers, which entered the market after deregulation and thus had more freedom to adapt and act according to the market conditions than incumbents, which were used to obey governments' advice, different kind of costs[134] served as forces for shaping their strategies. If the environment had been the same as before the deregulation, probably costs would not have been so such an important factor, however, since new entrants needed to compete with already established incumbents lowered fares, which can only be offered when managing costs effectively, was seen as the initial point of departure for entering competition. As a result low cost carriers fly short haul routes, focus only on point-to-point traffic, one cabin, have large share of their sale via internet and call centers.

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[132] Council Regulation (EEC) No. 2299/89 (O.J. L220/1,1989)
[133] see note 113
[134] refer to 3.10.4

6. Strategic Options of Incumbent Airlines

For a short while it seemed like incumbents were not really concerned about the competitive pressure from the low cost airlines; they perceived low cost airlines as not being in direct competition with them since low cost airlines aimed and attracted more leisure travelers and the main focus of the incumbents is the segment of business travelers. However, as we saw above[135] currently the number of business travelers taking services of low cost airlines is increasing. Apart from a few leisure oriented discount fares, incumbents did not seem to react to low fare airlines at all in the early to mid 1990. However, the launch of GO, a low fare carrier, some three years ago by British Airways might serve as an indication that incumbents became somehow worried about the emergence and expansion of low fare carriers. With the latest growth in discounting the incumbents have reacted in different degrees, although none of them have matched discount prices across their ranges. Their reaction can be summarized as focusing on improvement. There is a distinctive shift to differentiation and innovativeness as well as maintaining cost reductions and process efficiencies. As an example of innovations can serve incumbents concentration on the perception of being more price competitive. They have reduced some prices, introduced some cheaper fares, used frequent flyer points and increased price advertising. However, these offers have many restrictions such as requiring 14-day advance booking. Thus the lack of flexibility appeals to a small minority of leisure travelers rather than business travelers. Incumbents still concentrate on range, quality and ambiance and offering a long-haul service while targeting certain group of customers, and developing services according to their demands. At the same time they feel the need to adapt to the changed competitive environment and after the final deregulation of 1997 and entrance of low cost carriers in many markets incumbents are adopting certain strategies to cope with the competitive pressure. Thus in this chapter I am going to examine strategic options available and used by incumbent airlines after the emergence and expansion of low fare airlines.

6.1 Cost Reduction

Costs as mentioned previously represent an important factor why incumbents cannot compete on the same footing with low fare airlines. Operations from main hubs, frill-service, and wage structure all together influence the cost position of an incumbent. According to Michael Bishop "the economics of airlines' such as SAS, BA and KLM is that they cannot lose costs because they are tied in with long-haul products. They cannot come out of Heathrow, they cannot shed their frills."[136] Plus most of the incumbents have quite high labor costs. According to their labor costs, carriers were split in three categories in early 1990s. BA and KLM belong to first category, having relatively low labor costs. SAS together with already bankrupt Sabena belongs to second category, which consists of airlines having higher labor costs, however, these companies are working decisively on cutting these costs. The third category unites less efficient and high labor cost airlines, which have been less rigorous in their attempts to cut labor-costs. These carriers include: Air France, Finnair, Lufthansa and Iberia.[137] In this situation low cost carriers are in a very convenient situation since their cost structure is simpler and the intensified competition might force inefficient flag carriers to either downsize or go bankrupt. As Porter noted[138] "a firm pursuing overall differentiation can be attacked by firms that open up a large cost gap, narrow the extent of differentiation, shift the differentiation desired by buyers to other dimensions, or focus".

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[135] refer to 5.4

[136] Lockwood, C., (1998), "Cheap and Cheerful", Executive traveler, December/January

[137] Seristo, H., (1993), "Airline Strategies: Deregulation of the European Airline Industry", HSE Press, Helsinki p. 42

[138] refer to note 6

High costs are structural problem for many European airlines. The average large US airline has costs of around $0.09 per RPK(Revenue Per Passenger) compared to European average of $0.20. British Airways has always sought out methods that would improve its standing in the airlines industry concentrating principally on cost structure and aggressive marketing, with unit costs of $0.11 per RPK, is almost in line with US competitors. As for Lufthansa and Air France they have operating costs of $0.20 and $0.24 respectively. The failure of Air France to introduce modest cost restructuring package in 1993 suggests that many European flag carriers will not be able to adapt rapidly to meet the challenge. In a totally unregulated market Ellis[139] predicts that it is doubtful if any of the European flag carriers with the exception of BA and KLM will survive for more than a couple of years.

6.2 Formation of Alliances

Formation of alliances are driven by the desire to achieve marketing objectives and economies of scale, as well as for operational reasons, which enable airlines to share expenses for the provision of costly spares, such as aero-engines, in locations remote from base. Thus alliances create certain advantages, which can be used by participant incumbent airlines for winning better competitive situation than low fare airlines. How can this be done will be discussed below. Alliances are very important in the airline industry where economies of scale for increased profitability count for a lot in the face of competition, and where alliances allow airline's to become more competitive[140]. For example, alliances are designed to give airlines involved a stronger market base in an increasingly global industry and in particular strengthen their hub operations at key airports and to increase the scale of their networks. It is likely that both of these factors will play important role in determining the attractiveness of airlines' services. With the final deregulation since 1997, and increased competition from within the common market, the companies, which do not have partners are under a severe competitive invasion from those that do. These partnership usually take the form of an alliance and not a merger. And there are reasons for this. Despite the business logic that merger strategy would make it possible to serve a global market, governments do not wish to pass the ownership of their carriers to foreigners and therefore mergers between them are rarely approved. As Hodson narrates: "For many European governments, any failure to support a flag-carrier would be electoral suicide, and any significant downsizing of a national carrier would involve genuine political risk."[141] Thus airlines set up arrangements different from mergers, which typically include code-sharing and schedule co-ordination agreements, according to which airlines can create illusion of serving destinations that are in fact served by one airline. Such agreements particularly benefit airline partners with complementary networks. For example, European intercontinental airline's typically form alliances with US domestic carriers, which opens a network of connections to a much larger US hinterland area than would be served by their direct services alone. In addition alliances are preferred over mergers since as Ferguson[142] noted regional airlines in the US have generally operated with lower labor costs than their national counterparts. There is a possibility that the merger will cause the transfer of the higher labor costs from the national carrier. Besides merger will reduce the number of routes, which otherwise would be retained if carriers keep their nationalities.

Not long ago laws in Europe did not favor and actually forbade foreign ownership of a majority stake in domestic airline's shares. Nowadays these laws are more liberalized. BA took advantage of this situation to allow them to create a broader European network by taking a minority stake in TAT (French regional carrier), Air Liberete in France, and Deutsche BA in Germany. The reasons for this were explained by Robert Ayling, CEO of BA: "In these alliances we have

[139] Ellis, J., & Williams, D., (1995), "International Business Strategy", Pitman Publishing p. 26-28
[140] see note 6
[141] Hodson, C., (2002), "Which of Europe's Airlines will survive?", http://www.cnn.com/world, October 4
[142] see note 103

control over their operations, but the way the global aviation market is moving means that we will have to form alliances with players as big as ourselves to stay alive."[143] This action makes it possible for BA to get a strong foothold in these countries as well as provides it with feeder traffic for the possibly more lucrative long-haul services from Heathrow and strengthen its reach in the internal European market. Economies of scale have also been achieved with BA and Qantas (Australian national airline). For instance, through the following aspects – the seats on the aircraft, the style of catering, the cups and glassware bought. As Mr. Alying emphasized "it would be crazy not to seek economies of scale"[144]

One of the key issue for alliances is finding compatible partners to protect the brand image. Thus all the airlines participating in alliances should be able to provide equal level of service. It will need to be appropriate to customers' expectations. If the customer is transferred to the partner airline, the comfort and quality of the alternative provider must be the same throughout the whole journey.

Alliances can sweep away national monopolies and replace them with competing global carriers. In the process, economies of scale could be achieved, fares cut, passengers offered the convenience of choosing between a number of one-stop shops capable of flying them anywhere in the world. There is a risk that the industry may return to becoming a global cartel, continuing monopolistic traditions. This in turn can increase predatory behavior when dominant carriers drive out new and weaker rivals by pricing below average variable costs. Robert Crandell, chairman of American Airlines argues that the alliance between BA and American will result in decreased prices. Opponents claim that the idea of price decrease when the two largest companies in a market combine their operations is a novel contributed to economic theory[145].

6.3 Code Sharing

Code sharing is a marketing tool. It makes possible for two airlines involved as a rule through alliance or marketing agreement to use each others flights making arrangements simpler with airline's offering a seamless service with one ticket, one check in and one claim desk. Code sharing enables airlines to offer flights, which in reality is served by their partners, however, this creates the impression of a direct flight. This way carriers get access to more customers and expand route network at relatively low price. Code sharing has a number of advantages for carriers:

- Participant airlines can sell seats for each other's flights;
- There is a commercial advantage in attracting passengers on long-haul flights as it enables airlines' to overcome regulatory obstacles that prevent them from flying directly between two airports;
- Through marketing and commercial partnerships international reach and cost savings can be attained;
- The points collected from FFPs can be transferred from one partner to its code sharing partner;
- Airlines' acting as a single carrier can force other non-combined carriers out of the market. When this happens consumers may lose the benefits of competition;
- While using the same code the linked flight is displayed in a more prominent position on the CRS than alternative connecting services with carriers that use different codes.

Thus incumbent airlines might put low cost airlines under pressure, since they have superior marketing power attained by cooperation with partners, while low cost airlines do not really have any allies. According to Barry Perrot, the Managing Director of Jersey European Airways: "For

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[143] Gilmore, F., (1997), "Brand Warriors", Harper Collins p. 15
[144] see note 143
[145] Lex Column, (1996), "US Airline's", The Financial Times, February 14

small carriers in the UK it is seen that you are either in the BA network or out". In Europe BA has strong presence in the countries that it has alliances with, thus strengthening its reach in the internal European and global markets.

6.4 Fixing Prices

Price fixing is another tool, which can be used by incumbents to drive low cost airlines out of business. American Airlines' SABRE system offers an interesting example of a cartel using electronic signaling through its extensive use of reservations systems to control prices. For instance, if one carrier introduces a new low fare others might signal their displeasure by matching the new fare for only one or two days. Thus signaling that they would like to see the fare brought to an end. If that does not work they might take more drastic measures – for instance by cutting selected fares on some of the instigator's more profitable routes. Since many of these cuts happen so fast and for such short duration, consumers and even travel agents sometimes do not have time to find out about them before they are discounted, which allows airlines to achieve signal objective and bring discounter to terms. One problem of the behind-the-scenes battles is that the large carriers could use the system to inflict great damage on smaller airlines thus undercutting their ability to expand into new markets and blocking them from offering fares that are out of step with the major companies. Another concern is that instead of fighting each other, carriers could use their electronic signaling to set anti-competitive prices (Nomani, 1989). The use of computer network is a way of facilitating collusion. It has become common and probably the most questionable activity. Signaling discussion between airlines is played out like this: Carrier A often a small operator attempts to boost business by lowering ticket prices. It enters lower fares in the industry's computer system. In response, Carrier B, which is a dominant carrier at the affected airport not only matches the new fares but also lowers them in other markets that are served predominantly by Carrier A[146]. The end result is that Carrier A often cancels its reductions, depriving consumers of a lower fare. Another tactic is subtler. When any fare is changed even slightly, the electronic tariff program highlights it in the computer system. In response, another carrier makes certain move, which indicates that the fare should be changed back.

Antitrust laws make it illegal for companies to fix or even attempt to do so. Proving that this has happened is easier when prosecutors can show evidence of a face-to-face meeting or telephone call. Although the intent of law is clear when indirect signaling could be involved it is the evidence that is weak. It is important to determine whether "a seller's conduct is contrary to its independent self-interest" in a price fixing case. Cutting fares more deeply than necessary to undercut competition would appear to be intended as a warning to the competitive and economic reduction, especially if fares quickly return to a higher level. Many of the back-and-forth tactics in the airlines' industry appear to have little economic relevance to the market involved. To critics this supports the notion that airlines are often signaling as an anti-competitive measure rather than permitting supply and demand alone dictate fares[147].

6.5 Predatory Pricing

Predatory pricing occurs when an incumbent carrier or carriers reduces its price below average variable cost with the deliberate intention of driving out a new entrant. The cost of selling the last seat on a flight might be close to zero, but if taking the next passenger requires the use of an extra plane, it may be huge.[148] In the past low cost airlines, which tried to compete directly with the incumbents have suffered fatal consequences. For instance, Laker was driven out of business when the major transatlantic airlines including BA, reduced their fares to match the fares offered

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[146] Nomani, A., (1989), "Dispatches from the Airline Front", The Wall Street Journal, July 11
[147] see note 146
[148] Korah, V., (2000), "An Introductory Guide to EC Competition Law and Practice", Hart Publishing, p. 124

by Laker. In October, 1981, BA, Pan Am, and TWA agreed to reduce transatlantic fares by 66%. This reduction drove Laker out of business. Three months later they increase the fares back to the original rate[149]. More recently KLM was accused of predatory pricing during price war with Easy Jet. KLM had 40% of the London to Amsterdam market and offered the cheapest regular fare at FI 405 or roughly twice as much as Easy Jet offered. In response KLM reduced its fare to FI 95 one way, other carriers on the same route subsequently matched the lower price set by KLM[150] .
In January of 2002 Lufthansa was accused of predatory pricing by German's cartel office, which claims the airline's cheap flights between Berlin and Frankfurt are aimed at driving regional carrier Germania out of business.[151]

Thus in conclusion I would point out that out of the five strategic options discussed above, probably the most easily achievable and sustainable strategies are entering alliances and code sharing. Cost reduction is not an easy strategy and can be accomplished in the long-term perspective after wise planning of activities. As for the price fixing and predatory pricing none of them are legal and thus following these strategies will result in penalties and put incumbent in more disadvantageous situation.

[149] Glaister, K., & Clarke-Hill, C., (1995), "Cases in Strategic Management", Pitman Publishing, 2nd edition p. 59
[150] Cramb, G., (1996), "Easyjet attacks KLM on pricing", The Financial Times, August 2
[151] refer to note 4

7. September 11

According to Charles Hodson[152], the main problems accelerated in the airline industry in the wake of September 11th are:

* The collapse of some major flag-carriers;

* A public, which is uncertain and nervous about flying;

* A broad recession in the business;

* Steadfast opposition from the European Commission to state bailouts;

* An acknowledged problem of overcapacity in the industry.

Consequently, not all of the airlines found themselves in the same situation. According to their performance and position before the events of the September 11, their strengths and weaknesses placed them in different competitive situation. Incumbent and low fare airlines probably were not affected to the same degree, since as I mentioned above, first of all, the cost structure of these two types of companies is different and while Ryanair and its low cost counterparts could take certain steps for attracting more customers with lowered fares, the same action would make the situation even harder for the incumbents with inherent high cost structures. Luckily, not all of the incumbents followed this strategy. According to Mr. Mayrhuber, the Deputy Chief Executive of Lufthansa, when talking about the actions, which involve dumping prices on the North Atlantic, by United Airlines one of Lufthansa's partners in the star alliance, he disapproves by saying:" We complain of course. If you lower prices with no cost reduction, you kill yourself."[153] Unfortunately most of the time cost reduction is achieved by downsizing workers. And this trend gained stronger momentum after September 11. KLM Royal Dutch Airlines cut 2,500 jobs, British Airways'- 5,200 more jobs. The world's biggest airplane maker, Boeing Co. laid off more than 20,000 workers -- up to 15 percent of its work force -- as it expected a sharp drop in orders. All of these layoffs amount about 51,000 - the number of jobs that have been lost in the airlines industry since the September attacks.[154] Some incumbents started cutting capacity. As Mr. Mayrhuber points out "the crisis management lessons learned in the early 1990s had helped the group as aviation recession turned into crises after September 11. The airline managed to cut capacity by grounding 43 aircraft in a way that took nine months a decade ago."[155]

Another strong player such as BA has since November 2001 hemorrhaging $2.8 million a day, cut additional 7,200 jobs, reduced operations at London's Gatwick Airport and eliminated over 25% of its short-haul routes. Analysts expect BA will retreat upmarket, focusing on business travelers and eliminating all but the most lucrative short routes. BA is also beginning to use much smaller planes, enabling it to reduce capacity while increasing frequency. Thus we see that in the aftermath of the September 11th events, BA was forced to take this kind of actions. And as Christine Tierney notes: "If BA's experience is any indication, Europe's flag carriers are in for a rough ride. They could embark on a prolonged and painful period of restructuring, which only works after great effort, or they could do a quick revamp. Either way, they could find the likes of Ryanair still breathing down their necks, chipping away at their profits and never giving them a moment's rest."[156] However, low cost airlines give us a picture of performance, which differs

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[152] Hodson, C., (2002), "Which of Europe's Airlines will survive?", http://cnn.com/world, October 4
[153] Done, K., (2002), "Wind of change set to blast into Lufthansa", The Financial Times, April 30
[154] "European Airlines in Crises", http://cnn.com/world, November 7, 2001
[155] Done, K., (2002), "Wind of change set to blast into Lufthansa", The Financial Times, April 30
[156] Tierney, C., & Capell, K., & Matlack, C., (2002), " Day of the discounters", Business Week, February 11

from that of their older counterparts a great deal. They do not seem to be badly affected by the September 11th events and even the opposite might be true. They continue to grow by expanding in other countries and they profits soar, while the situation of the incumbents seems to be getting more and more serious. KLM's net losses for the three months to March 31, 2002 were up by 22 percent to EUR108 million (USD$98.9 million). While in the same period last year KLM lost EUR88 million.[157] As for the low cost airlines, Easy Jet announced on May 8,2002 that it made profits of GBP£1 million (USD$1.46 million) in the six months to March, overturning a GBP£10 million loss in the same period last year. The same day Easy Jet stroke a deal to buy BA's German subsidiary – Deutsche BA. The deal is worth between GBP£18.3 million (USD$26.7 million) and GBP£28 million (USD$40.9 million). Deutsche BA chairman Roger Maynard, explaining the reasoning behind the sale of Germany's second largest scheduled carrier, said: "Flying exclusively in the German market means there is no longer a strategic rationale to retain DBA in the British Airways group. The decision to sell the subsidiary is in line with British Airways' Future Size and Shape package of measures to reduce costs and return the business to profitability."[158] Thus EasyJet will become the biggest low cost airline, and it can be assumed that it grows at the expense of the poor performance of the incumbent, in this case BA.

In general the passenger growth for low fare airlines is expected to average 25%-30% for the remainder of the decade. As for the flag carriers this figure amounts to 5% only.[159] In this situation it is extremely interesting to examine the situation within a certain market where the national flag carrier is competing with low fare carriers. For this purpose I have decided to choose SAS and Scandinavian market. In the next chapter, which is a case study of the SAS and low fare airlines in Scandinavia, I am going to analyze the competition issues on Scandinavian market.

[157] "KLM optimistic despite increased losses", http://www.airwise.com, May 8, 2002
[158] "EasyJet buys BA's German Subsidiary", http://www.airwise.com, May 8, 2000
[159] refer to note 152

8. Case Study: Ryanair and GO vs. SAS

The European airline industry has since the final liberalization in April 1997 been facing until now unprecedented challenge. The competition has become free, new customer trends have been observed, which means that the field constantly has to adapt to changing and more demanding customer needs. At the same time, transport via air has radically changed from being luxurious for the few to now being the natural transport form for the many. This situation demands broad focus on the competition situation and its important to choose the strategy, which could bring the single player to the advantageous position compared to competitors. Low cost carriers have increased their traffic offers during the last couple of years dramatically. For instance, EasyJet, Ryanair, and Debonair in 1996 had 533 daily departures from the London area, while Ryanair, Easyjet and GO in 2000 had 1,664 daily departures out of the London area. [160]

8.1 SAS View on Low Cost Carriers

To be able to say if low cost carriers are or will become future competitors to SAS it is important first to have an idea about what segments is SAS focusing on to define whether it competes with low cost airlines directly. Competitors in the field are those who try to meet the same needs for the same customers. The business travelers are SAS primary target group. In the first priority SAS planning, building resources and developments of services and products is aiming at the fulfilling the needs of business travelers. Since the number of leisure travelers is growing faster than the number of business travelers, SAS has developed traveling program for this segment called SAS Pleasure, to be able to offer the private travelers services at competitive conditions.
The business traffic consists of 83% of SAS production, which furthermore is strengthening SAS's primarily strategy to focus on the business traffic between Scandinavia and the rest of the world while the leisure segment consists of the remaining 17%. This segment represents price sensitive and well-informed leisure traveling customers, which has its base in flexible young people for whom the flight only is seen as being a transportation from A to B and nothing else. What is most remarkable about this segment is that low prices create new markets, new customers who would not have traveled or used air if the prices had been higher. This segment, which is actively asking for the lowest price is, between for instance, Scandinavia and UK, relatively big and SAS's production group was counting on approximately 100,000 individuals from Stockholm to London and 50,000 individuals from Copenhagen and London yearly. This is the segment where SAS faces direct competition with the low cost carriers.

8.2 Low Cost Carriers Production Shares in Scandinavia

Weekly Frequencies									
Lon-Scandinavia		SAS	Index	BA	Index	Ryanair (FR)	Index	Go	Index
	W 98	178	100	168	100	46	100	18	100
	S99	178	100	156	93	39	85	19	106
	W99	191	107	159	95	52	113	25	139
	S00	182	102	145	86	52	113	25	139
	W00	182	102	145	86	65	141	25	139
	S01	174	98	145	86	79	172	19	106
Share 1998		36%		34%		9%		4%	
Share 1999		40%		33%		11%		5%	
Share 2000		39%		31%		14%		5%	

[160] ECA report 22 Jan, 2001

Share 2001		38%		32%		17%		4%	

The indexes are based on traffic program W98 vs S98; W99 vs S98 etc. Normally airlines have 2 traffic programs per year - a summer program and a winter program which are reflected in the indexes.

Source: Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?

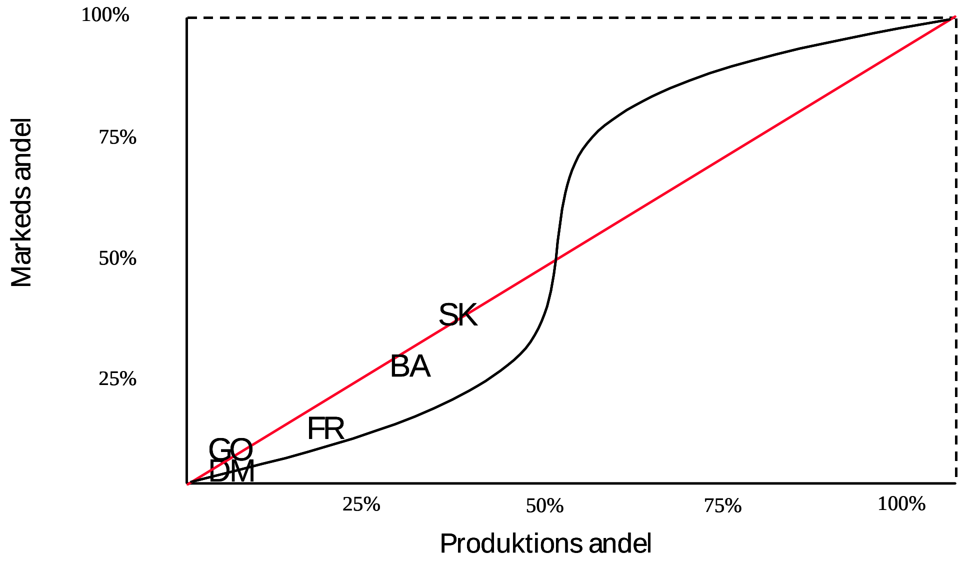
From the table above it could be seen that SAS and BA continuously have the biggest production shares but it is worth noting that Ryanair is now up at 17% of the production between Scandinavia and London. The reasons of the raise in production shares could be attributed to flying on more secondary destinations in Scandinavia and it is thus not an expression of a raise in the number of frequencies on existing routes. GO however, showed a raise of their production share during part of 1999 and 2000. As they went from two daily operations at Copenhagen to four, but has due to falling results since the winter program 2000/2001 again reduced to 2 daily frequencies. GO has today only 4% of the total production and is thus reduced to limited actor in Scandinavia. However, Ryanair has developed very positively during the years and has reached reasonably high production share. With such a production share it is interesting to look at how big is the share of the traffic between Scandinavia and London that low cost carriers today are having. The table below shows the market shares of different companies in 2000.

Airline	Share
SAS	36%
BA	27%
Ryanair (FR)	20%
GO	7%
Maersk Air (DM)	3%

Source: Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?”

To be able to measure if low cost carriers have a bigger share of Scandinavian market than they should have due to their production share, Wandahl (2001) suggests the theoretical S curve model to for estimation. The model shows the relationship between the market and production shares. From the picture below, it can be assumed that SAS compared to its production share has higher market share than it is theoretically entitled to. Also it could be seen that both BA and Ryanair (FR) have less market share than their production shares entitle them to. “You could therefore conclude that SAS with the production machinery that we have from London is very competitive since we have higher market shares than our production entitles us to, and thus we should not be scared of the low cost companies developing on Scandinavia. If we put in more capacity we will automatically get higher market shares due to our strong market position in both Scandinavia and London.”[161]

[161] Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?” p.10



Production Share

Source: Wandahl, T., (2001) "Bilver low-cost carriers over en 5 arig periode en trussel for SAS?"

8.3 SAS's Revenue Competing with Low-Cost Carriers

To be able to measure if Ryanair's comparably high production share of the traffic between London and Scandinavia will be a threat to SAS in short term, it is important to investigate how big is the share of SAS's total revenue facing competition with low cost carriers. The appendix 1 shows the share of SAS revenue on the different European markets and it could thus be seen that maximum 13% of SAS incomes are today facing competition with low cost carriers. According to Wandahl (2001): "If we look further on how much of those 13% that consists of leisure travelers then we are up at maximum 5% of SAS's total incomes, and thus the threat is very limited for SAS."

However, the situation seems to be different from the Ryanair's prospective. In Scandinavia currently it operates flights from 7 airports: Esbjerg, Gothenborg Save, Malmo Sturup, Stockholm Vasteras, Stockholm Skavsta, Aarhus and Oslo Torp. The particular interest can be seen in Norwegian market. Especially considering that Ryanair has been the only airline expanding in Scandinavia since September 11. It started to operate a new route Oslo Torp-Frankfurt Hahn just a couple of months ago, thus increasing the number of destinations from Oslo to three (Oslo Torp-Stansted and Oslo Torp-Glasgow Prestwick). Ryanair suggests convincing reasons for this expansion. The number of its passengers in 2001 equaled 130,000 in 2002 the number increased to 300,000 and according to its projections in 2003 the number of passengers will reach 1,050,000. At this point company even questions establishing its fifth European base in Norway. According to Ryanair it is the high time to expand in Scandinavia since the merger between SAS and Braathens decreased competition, which in turn increased prices, as a result fewer passengers fly, the route networks shrink and regions get economic damage. In addition some of the airlines have cancelled their operations in Scandinavia. Namely BA left Gothenburg, US Airlines Stockholm, there are no direct services from Norway to USA, SAS has cancelled Oslo/Dublin and Oslo/Manchester operations, Color Air ceased operations, Air Botnia cancelled Bergen-Stansted, and there are only two daily flights from regional Norway to London. Lately in April, 2002 SAS also announced about dropping thirteen destinations, most of which are on Norwegian market: Tromso-Alta/Lakselv/Kirknes; Evenes-

Tromso/Bodo/Trondheim; Lakselv-Kirkenes.[162] According to SAS's information director Hans Ollongren: "routes we have cancelled don't give profit so we hope they will be flown by somebody else so that the traffic supply for these destinations will be secured."[163] In this situation Ryanair plans to emerge as a reviver of declining tourism and plans to bring regions in the same line with Oslo's transportation possibilities. Low cost is seen as the only solution to the situation by Ryanair and guarantees further growth of the traffic by establishing long-term low cost deals with Norwegian airports and engaging in partnerships with national and local tourist and business organizations.

Ryanair plans to launch flights from Oslo Torp to - Tromso, - Bodo and - Evenes. There is also possibility for starting operations from Bergen to Tromso and Bodo. As it can be seen below the preliminary prices suggested by Ryanair on the routes to Oslo are almost 5 times cheaper than the ones offered by SAS/Braathens.

SAS/Braathens

	Midweek	Flexible
Tromso	1900	5860
Bodo	1900	5455
Evenes	2155	5750

Ryanair

	Midweek	Flexible
Tromso	364	2500
Bodo	396	2700
Evenes	410	2700

- Prices are in Norwegian Krone
- Prices do not include taxes

Source: www.ryanair.com

As a result of lowered fares Ryanair predicts following increase in the number of passengers from these towns to Oslo:

Airport	Current	Ryanair	Increase
Tromso	697,000	997,000	43%
Bodo	492,000	692,000	41%
Evenes	303,000	403,000	33%

Source: www.ryanair.com

Moreover, according to the estimations Ryanair hopes to get 100,000 extra passengers per annum from each daily frequency.

Establishing flights within Norway might serve as an indication for the future intra-Scandinavian expansion, which will not be a positive thing for SAS, since that accounts for the 49% of the total incomes (refer to Appendix 3). However, this is not considered as a possible scenario within short time period since "the business prices in Scandinavia compared to the rest of Europe are not so high that there should be incentive for low cost carrier to break in" comments Wandahl. As Appendix 4 shows SAS's business prices are up to 12% lower than in France while they are up to 15% lower than in England that after all is dominated by low cost carriers. Thus there is a

[162] " SAS Group streamlines traffic system and creates platform for long-term profitability and growth" 17.04.2002 available at http://scandinavian.net

[163] "Flygindustrin är i en djup kris", Aftonblandet, May 21, 2002

possibility that Ryanair will limit its operations to small towns within Norway and will not start offering attractive deals for business travelers. As for the leisure segment it could be seen in the Appendix 5 that the prices are on average around 10-12% below the domestic prices both in the English and French markets. Ryanair has several times declared that it has an interest in starting to fly on Swedish domestic destinations. However, as we can see in Appendix 6 the markets are relatively small with the exception of Stockholm-Gothenburg and Oslo-Bergen. Both of these flights have relatively big traffic base. However, the business traffic on STO-GOT is around 77% of the total traffic, which means that Ryanair has to introduce many frequencies to take a part of this traffic and at the same time they are competing with both fast trains and with Malmo Aviation.
Other options of competition development also involve Ryanair's further expansion on secondary airports. Out of the seven airports, which Ryanair operates from today, four belong to Swedish market. Ryanair and GO have almost doubled their traffic number over the two-year period. This should be seen together with their production share between Scandinavia and London that has risen from 13-21%.[164] If we look at SAS's development on London during the same period it could be concluded that it had a strong growth during 1999 and a more moderate growth during year 2000. The table below shows SAS's Cabin Factor (C/F) development 2000 vs.1999. From the tables below we can see that SAS in general has a higher coverage than both Ryanair and GO and that they have capacity to take a big part of the price sensitive segment. However, SAS had the capacity on STN but did not achieve sales to the same extent as Ryanair and GO, and consequently was forced to leave Malmo Sturup – London Stansted market since winter 2001.

SAS Cabin Factor 2000 vs. 1999

Origin and Destination	Cabin Factor
OSL-LHR	67%
STO-LHR	77%
CPH-LHR	74%
CPH-STN	53%

Ryanair's and GO's Cabin Factor

Origin and Destination	Cabin Factor
KID-STN	66%
TRF-STN	66%
AAR-STN	62%
CPH-STN	67%
NYO-STN	68%
MMX-STN	61%

Source: Wandahl, T., (2001) "Bilver low-cost carriers over en 5 arig periode en trussel for SAS?"

Regardless of the loss at Malmo Sturup –London Stansted destination, Mr. Wandahl still sounds optimistic and states: "Ryanair's and Go's development on Scandinavia should not be feared since they only stimulate demand that SAS did not have place for or didn't focus on developing." Even though the coverage of low cost carriers is not as large as of SAS, GO still became attractive to business segment when it increased frequencies from three to four daily flights in November 1999. However, this situation did not last long. SAS lowered fares from 698 DKK to

[164] Wandahl, T., (2001) "Bilver low-cost carriers over en 5 arig periode en trussel for SAS?" p.12

320 DKK (excluding tax) to CPH-STN destination. And soon (September 2000) GO was forced to decrease frequencies to three; and in summer 2001 GO went down to two frequencies. The fear with Ryanair's or GO's expansion on more secondary airports in the short term period is that SAS will lose some of its "network traffic", since the customer base for London flights will be undermined to certain extent. To remedy the situation SAS has introduced new offers for youth, which start from 895 SEK excluding taxes. However, most of the low cost airlines' deals are still below the fare introduced by SAS.

It is also possible that Ryanair increases frequencies on the existing destinations. It should be noted that Ryanair has already declared that it wants to increase frequencies VST-STN from one to two daily departures. If Ryanair changes frequency strategy especially on GOT- STN, OSLO-STN and VST-STN and NYO-STN that could be a trouble for SAS since for the business traffic frequencies are the most important factor. However, since Skavsta and Vasteras are too far away from Stockholm it might not be easy to make this segment move to Ryanair's flights. There is however, a possibility that Ryanair will be able to take part of the business traffic from both Gothenburg and Oslo since they have the same advantage as SAS. However, Eurobonus and the contracted traffic mean that the share of the traffic that Ryanair might attract could still be limited. As for GO it is unlikely that they will pursue the increased frequency strategy again since within a year it annulled two frequencies on CPH-STN.

In order to examine the possible future developments on the Scandinavian market, Day's scenario questions might be applied. [165] Since Scandinavian market is not so big as for example British market, it is obvious that market can support fewer competitors. When it come to low cost carriers it is seldom that there is more than one low cost carrier at one O&D[166] and it seems therefore as if you indirectly or directly have split the markets between them.[167] From the sizes of the markets it could also be seen that English market is much bigger than for example Swedish. In comparison to this could be mentioned that the biggest O&D to and from Swedish market is Stockholm-London with the yearly market size of 691,000 passengers while the second biggest is Stockholm-Gothenburg with the yearly market size of 393,000 passengers. The same is true for the Danish and Norwegian markets, however, to smaller scale. It is hard to define how many competitors will the Scandinavian market be able to support in the long run, however, as Wandahl suggests, because of the limited size of the Scandinavian market there will be a place for only one low cost carrier together with the incumbents already on market.[168] However, already now there are two low cost carriers – Ryanair and GO competing with incumbents, and since 14th of June a new local Swedish low cost carrier Goodjet will start its operations from Sweden and Norway to France namely to Paris and Nice. Thus as it can be seen there are already at least three low cost candidates involved for establishing themselves on Scandinavian market. The increasing number of entrants puts more pressure on incumbents as well. Even though SAS is seen as a company with strong growth opportunities by its managers; at this point it is a fact that every day the company is losing 14,4 Million SEK. Half of the management has disappeared, Marie Ehrling, Executive Vice President of the SAS Group and current head of SAS Airline, is to leave SAS at her own request being with the company for 18 years.[169]

The trend of increasing number of airlines operating on Scandinavian market is likely to trigger a shakeout, and it is extremely important for SAS to define, its position as well as evaluate power of its competitors. Ryanair seems to be the strongest and the most established low cost carrier in Scandinavia. It is the only airline in Europe, which has been profitable for the last eleven years and has good growth opportunities. As for GO, it is likely that it will be purchased by Easyjet from its current owner venture capital company 3i, in a USD546.4 million deal and thus its

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[165] see note 8
[166] Origin and Destination
[167] Wandahl, T., (2001) "Bilver low-cost carriers over en 5 arig periode en trussel for SAS?" p.5
[168] see note 168
[169] Lindham, E., (2002) "Ehrlings avhopp början till slutet?", Aftonblandet, May 21

future depends on the decisions of Easyjet.[170] As for Goodjet at this point it is hard to make any kind of prediction. As for SAS it can be said that at this point probably it will not benefit from accelerating a shakeout since it just started to acknowledge long-term threat posed by low cost carriers and initiated the steps for improving its market positions. As the CEO Jørgen Lindegaard states: “We want to become company for ordinary people. The low price companies have shown that things can be done more efficiently”.[171] The strategy to remedy the situation seems to be on its way. Splitting company in four independent units, is seen as a step forward, Hans Ollongren points out: “The units that now have been split could compete like independent companies with other service providers within these areas independently, since they get greater commercial freedom”.[172] By dividing the company into four entities improvements in performance are expected to be achieved. However, Bo Sehlberg, expert in the field states: ”The structure does not mean anything the company has high costs and little income”.[173] In the meantime Jørgen Lindegaard asserts: ”We will make greater use of the Group’s economies of scale and create a more distinct distribution of roles between the airlines within the Group. We will also become more efficient at developing other related operations. For SAS Airlines, this change is another step on the path in the goal-oriented change process, which is being driven by Marie Ehrling. A structure is being created that will generate new business opportunities for service units, as well as opening new possibilities for other Group companies.”[174] The SAS Group will thereby be operated within the framework of the following areas: SAS Airline, Subsidiary & Affiliated Airlines, Airline Support, Airline Related Businesses and Hotels.

In conclusion I would say that the future development of the competition and the whole competitive situation is quite hard to predict. From the materials presented above it can be seen that in the short term perspective it seems like there is no real threat to the operations of SAS, however, in the long term perspective the situation might be different, since a number of low cost carriers in Scandinavia tend to increase, thus increasing the chances for the shakeout of the market. Thus if SAS does not adapt to the changed environment around it simply might find itself in the situation where its business customers together with the relatively few leisure travelers get lured away by low cost competitors.

[170] “Easyjet agrees to buy rival GO”, http://www.airwise.com; May 16, 2002
[171] Lindham, E., (2002) “Ehrlings avhopp början till slutet?”, Aftonblandet, May 21
[172] see note 43
[173] Aftonblandet staff interview with Hans Ollongren (2002) “Flygindustrin är i en djup kris”, Aftonblandet, May 21
[174] http://www.scandinavian.net

9. Conclusions

The airline industry is undergoing hard time after the deregulation. Incumbents are facing increased competition from the new entrants- low cost airlines and try to keep their market share, which is mainly composed of business travelers to themselves. At the same time low cost airlines by providing low cost, point-to-point services try to compete with incumbents. Strategies of both incumbent and low cost carriers are shaped by five competitive forces dominant on the market. These forces determine the success of each of the category of airlines to some extent and influence their choice of certain strategies. the most important force, which shaped the strategies of the incumbent airlines was regulated environment. Since for a long time until the deregulation of 1993, governments had great control over the flag carriers, and bilateral agreements guaranteed virtually no competition, that could damage European incumbent carriers, they started to pursue, expensive strategies, which are used to great extent at present as well. The strategies include operations from big centralized airports, building hub-and-spoke networks, participation in CRS, high remuneration of the work force, ticketing services, luxurious lounges for business travelers. As for the strategies of low cost carriers, which entered the market after deregulation and thus had more freedom to adapt and act according to the market conditions than incumbents, which were used to obey governments' advice, different kind of costs[175] served as forces for shaping their strategies. If the environment had been the same as before the deregulation, probably costs would not have been such an important factor, however, since new entrants needed to compete with already established incumbents lower fares, which can only be offered when managing costs effectively, was seen as the initial point of departure for entering competition. As a result low cost carriers fly short haul routes, focus only on point-to-point traffic, one cabin, have large share of their sale via internet and call centers. This kind of operations make it possible for low cost airlines to keep their costs low, expand by entering new markets and increase their share of profits. For a while after the emergence of the low cost phenomenon in Europe incumbents did not see any threat in the competition with them. However, it seems that the approach has changed as BA's launched GO in 1998, fares were lowered by some incumbent airlines[176], they also increased use of FFPs. In general there are five strategic options available and used by incumbents in competition with low cost airlines. **Cost reduction** is an important strategy since incumbents have inherited high costs due to the salary structures, frill-services and the hub airports they operate from. **Alliances** are important since they allow for the economies of scale and in general put incumbents in better competitive situation by strengthening their hub operations and increasing the scale of their networks. **Code Sharing** enables incumbent airlines to create the image of operating the flight, which in reality is served by their partners. Code sharing makes the feeling of direct flight, which naturally in turn helps to attract more customers. **Price fixing**, which is illegal but still sometimes pursued by incumbents facilitates agreement on certain prices between incumbents and it can cause damage to low cost airlines since lowered fares might disturb its ability to match the fares and thus even might undercut its expansion potential in new markets. **Predatory pricing** is also illegal activity, which nonetheless historically has been pursued by airlines in order to drive new entrants out of business. Of these five options, probably the most easily achievable and sustainable strategies are entering alliances and code sharing. Cost reduction is not an easy strategy and can be accomplished in the long-term perspective after wise planning of activities. Both price fixing and predatory pricing none of them are legal and thus following these strategies will result in penalties and put incumbent in more disadvantageous situation.

As for the increased competition and its consequences on the incumbent airlines, observing Scandinavian example by following the case study it might be concluded that in the relatively short term period it might be difficult for low cost airlines to attract vast numbers of business

[175] refer to 3.5.4

[176] SAS introduced SAS Pleasure, lowered fares for leisure market

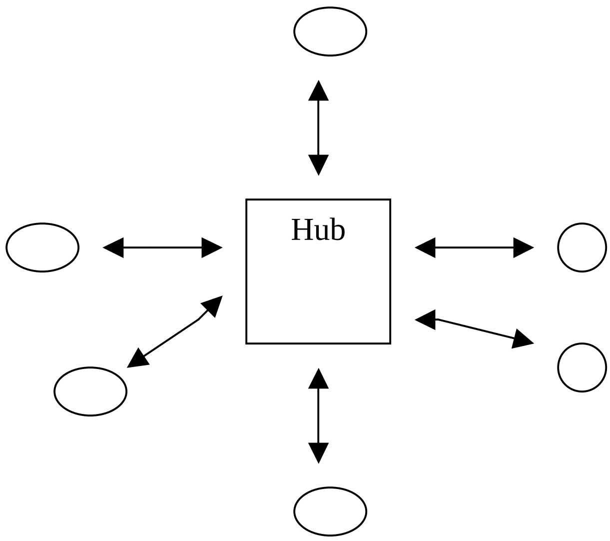
passengers, while on the other hand their success with leisure travelers in Scandinavia should not be questioned at this point. However, with the increased trend in Europe and namely in UK where already around 20% of business travelers are taking low cost airlines, even though the prices in Scandinavia are 10% below the prices in the UK, I would still think that with the increased frequencies and low fares, low cost airlines could attract business segment as well. In addition with the increased use of internet, creating extensive webs, and increasing intranet solutions could make it easier for example, for Ryanair to get into business segment and this solution could maybe compensate a smaller route network.

Even though, the focus of low costs is defined as focus on leisure travel, since they do not offer many frequencies, operate from secondary airports, provide no on-board meals, we should not forget that most of the times leisure travelers are young people, and there is a great possibility that some of them will become businesspeople in a couple of years, and I am positive that the loyalty to the service they will use over and over again during young age will not disappear without a trace and will serve as an incentive to use same low cost services even on business. In particular it should be noted that big companies like Merrill Lunch for example are already starting to offer their executives cheaper flight options with low cost airlines. And this is quite understandable. Why will any company feel comfortable spending at least twice as much on the tickets offered by incumbent carriers when it is possible to use the services of low cost carriers. However, hopefully there will still always be some exceptional circumstances, which will work for the benefit of the incumbents. So as long as there is that hope, and time to try changing underlying costs of the operations, European incumbents still have a chance to keep their positions on the market.

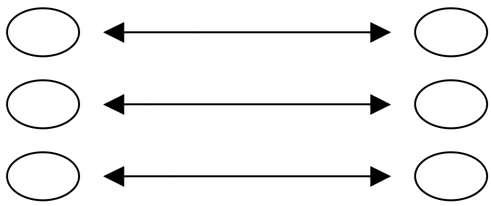
APPENDICES

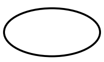
Appendix 1

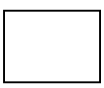
Hub-and-Spoke system



Point-to-Point System



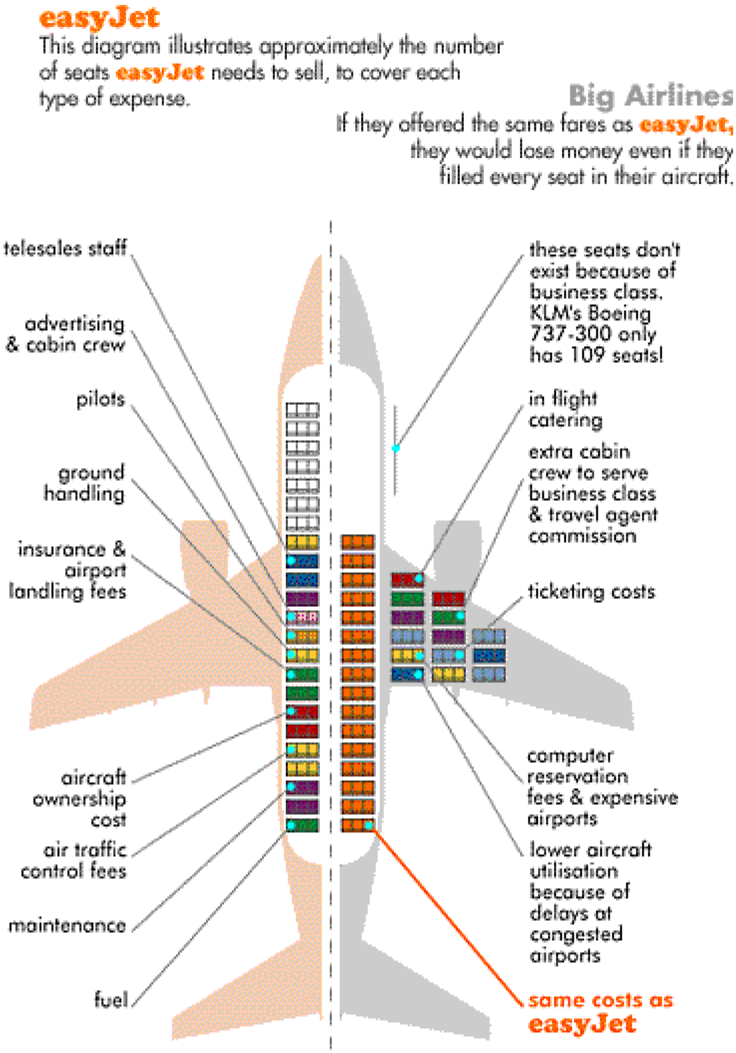
Spoke 

Hub 

Source: Fergusson (1993)

Appendix 2

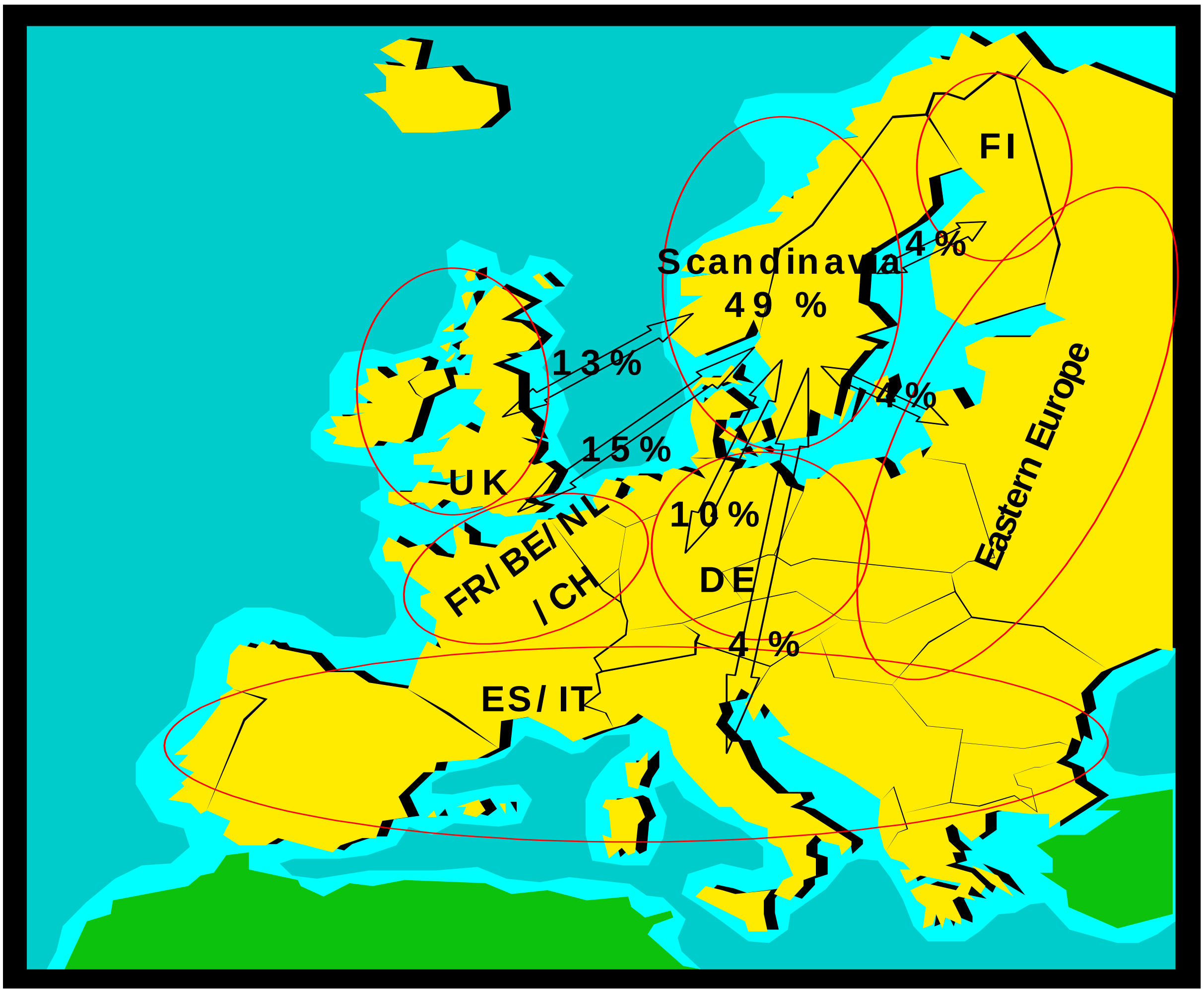
Overview of cost differences between low cost and flag carriers



Source: http://www.easyjet.com

Appendix 3

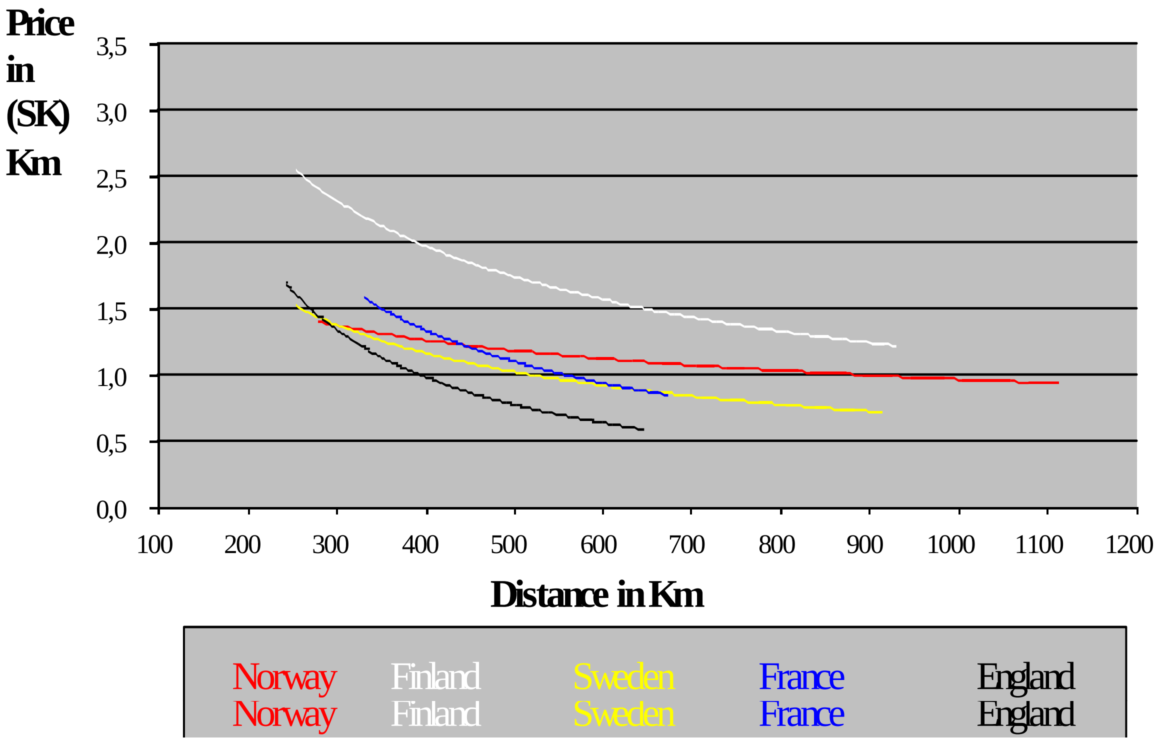
SAS Revenues around Europe



Source: Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?”

Appendix 4

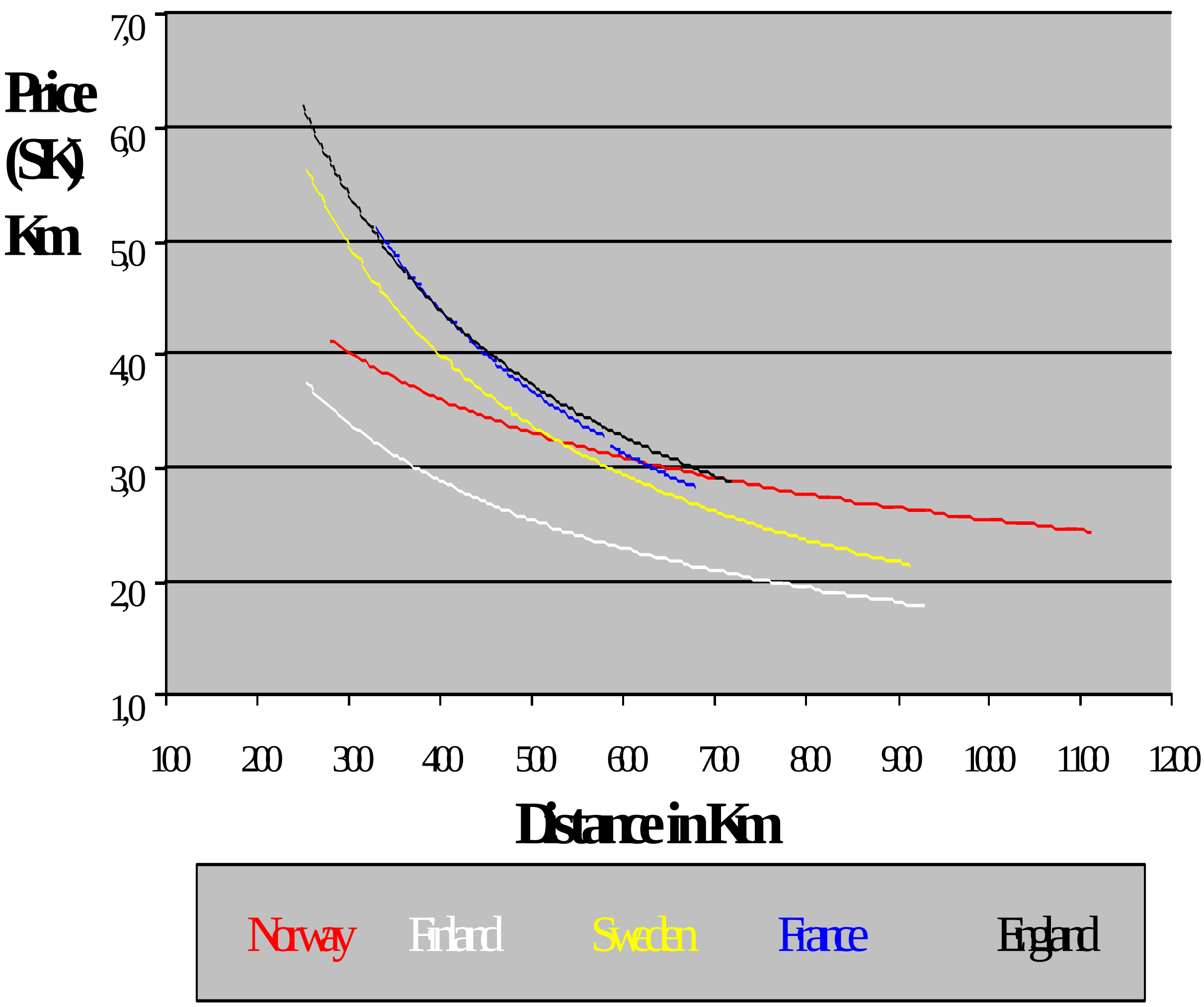
Business prices on certain domestic markets



Source: Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?”

Appendix 5

Leisure prices for certain domestic markets



Source: Wandahl, T., (2001) “Bilver low-cost carriers over en 5 arig periode en trussel for SAS?”

Appendix 6

Market sizes for 2000

Göteborg		Low	Low
Got -	647.00		
Got -	222.00	FR	
Got -	88.00		
Got -	83.00		
Got -	78.00		
Got -	63.00		
Got -	63.00		

Bruxelles		Low	Low
Bru -	580.00	FR	TV
Bru -	290.00		TV
Bru -	281.00		TV
Bru -	272.00		TV
Bru -	201.00		
Bru -	192.00		TV
Bru -	180.00		
Bru -	172.00		
Bru -	168.00		
Bru -	167.00		
Bru -	150.00		
Bru -	149.00		
Bru -	149.00		
Bru -	144.00		TV

Copenhagen		Low	Low
Cph -	392.00		
Cph -	409.00		
Cph -	255.00		
Cph -	253.00		
Cph -	187.00		
Cph -	155.00		
Cph -	155.00		
Cph -	144.00		
Cph -	143.00		
Cph -	120.00		
Cph -	95.00		
Cph -	79.00		

Stockholm		C/CL	Low
Sto -	692.00	50%	FR
Sto -	647.00	77%	
Sto -	392.00	70%	
Sto -	384.00	76%	
Sto -	357.00	70%	
Sto -	335.00	76%	
Sto -	331.00	45%	
Sto -	253.00	21%	
Sto -	252.00	47%	
Sto -	209.00	26%	
Sto -	167.00	42%	
Sto -	157.00	73%	
Sto -	153.00	71%	
Sto -	133.00	53%	
Sto -	121.00	37%	
Sto -	106.00	23%	

Oslo		Low	Low
Osl -	541.00		
Osl -	495.00		
Osl -	412.00		
Osl -	394.00		
Osl -	384.00		
Osl -	255.00		
Osl -	154.00		
Osl -	142.00		
Osl -	131.00		
Osl -	121.00		
Osl -	120.00		
Osl -	98.00		

Source: MIDT

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