OnLine Case 2.3
Deregulation and the international airline industry

When governments regulated their airline industries, in order to control both national and international competition, new airlines were prevented from entering markets, existing companies could not simply offer flights into or out of any airport of their choice, routes could not be poached and prices for specified routes were fixed.

This regulation has been systematically reduced since the late 1970s. At this time in the USA, where flying is as commonplace as bus and train journeys, and airline seats are perceived as essentially a commodity product, domestic competition was opened up. This has unleashed the underlying competitive nature of the industry with dramatic effects. The industry is characterized by chaos.

It is relatively easy to break into the industry once companies are allowed to do so. Planes can be leased and funded from revenue; maintenance can be bought in. Normally both fuel and planes are easily obtained. A company can enter by offering a limited service and concentrating on particular cities. Deregulation in the USA attracted such companies; and existing large airlines sought to expand their routes. Buyers were generally willing to fly with the airline which offered a flight at the time they wanted to travel, not differentiating, rather than building their arrangements around the schedule of their first-choice airline.

The British government has sought competition rather than monopoly control in the UK, privatizing British Airways in 1987. In 1991 the CAA (Civil Aviation Authority) relaxed certain rules, allowing new airlines to fly into and out of Heathrow for the first time since 1977. This intensified transatlantic competition as two strong US airlines (American and United, the two largest airlines in the world), which were restricted to Gatwick, acquired Heathrow/America routes from two weaker competitors, TWA and Pan Am respectively. At the same time Virgin Atlantic was: allowed to operate from Heathrow as well as Gatwick; allowed to fly to more American destinations; and given a number of BA’s slots on the lucrative Heathrow to Tokyo route. All of these changes increased the competition for BA.

In 1992 European Union transport ministers agreed plans for a new ‘open skies’ policy, eventually featuring:

- Freer access for airlines to new routes throughout Europe. Previously many routes have been protected by governments to prevent competition with their national carriers. One difficulty in implementing this is the ability of air traffic controllers to cope with more flights; European air traffic control is not fully co-ordinated and is overstretched.

- Greater freedom for airlines to set their own seat prices, within certain protective safeguards. This did not imply that prices would fall quickly because operating costs are already high, with many flights operating below capacity.

- Lower barriers to entry for new carriers.

Deregulation began in Australia in 1990, when controls on prices and schedules were removed, resulting in domestic price warfare, cost cutting measures and the entry of a new national airline, ‘the first for decades’. British Airways was allowed to buy a substantial shareholding in Qantas, Australia’s leading international airline.

Effects

o New route strategies based on ‘a hub and spokes’ – flights are concentrated around particular regional centres. American control 65% of the slots at Dallas; United own 68% of the slots at Washington National and 48% of Chicago; and Delta 70% of Atlanta. Internationally carriers expect the same control at the major airport in their home country, but many are now seeking to establish further hubs around the world.

o Company winners and losers. In 1991 in the USA, for example, two previously major competitors, Eastern and Pan Am, went out of business. Earlier People Express, founded in the USA in the early 1980s (following deregulation) to offer cheaper price flights, also failed after rapid growth and profitability. Companies such as American, United and Delta, less well-known before deregulation, have grown dramatically. In 2008 Delta merged with the smaller Northwestern to create the world’s largest airline. One European national carrier losing serious money is Alitalia.

o New, small, focused airlines have also proved successful. We saw earlier how Southwest Air, based in Dallas, flies point-to-point (not hub-and-spoke) on short-haul routes, offering low fares, no pre-assigned seating and calling at secondary airports. Empowered employees deliver high service – founder Herb Kelleher has ‘made working in this business an adventure for the employees’. The company uses only one type of aircraft, Boeing 737s, and avoids computer reservation systems in travel agencies; it prefers direct sales to its customers. Southwest has been consistently profitable; its operating ratios confirm that it out-performs most other US airlines. The Southwest strategy has been followed to varying degrees in the UK and Europe by competitors such as EasyJet and Ryanair, as well as by Go (BA) and Buzz (KLM of the Netherlands) before they were acquired by EasyJet and Ryanair respectively.

o New joint venture agreements and cross-shareholdings. In July 1992 BA reached an agreement with financially-troubled US Air (the fourth largest US carrier) to acquire a shareholding, and thereby gain access to US domestic routes. This arrangement collapsed when BA and American began to discuss a strategic alliance. The alliance they proposed has never materialized, although there are code-sharing links between the two airlines. In Europe Air France merged with KLM and BA is in serious discussion about merging with Iberia (Spain), with which it already has an alliance.

o Increased competitiveness with job losses during recession. Events like the 1991 Gulf War and 9/11 can have a major impact if people are deterred from flying.

o Greater reliance on information technology to allow pricing flexibility in order to maximize load factors. However, the increasing number of ‘price wars’ and special low-fare promotions has led to non-optimum fare mixes and unprofitable flights. In 1994 in the USA, for example, 92% of passengers flew on discount tickets and the average fare paid was just 35% of the published full fare. During the 1990s the real cost of trans-Atlantic flights halved. It is hardly surprising that customers have become increasingly confused. At the end of the 1990s BA chose to change its strategy and increase the number of its premium-price business and first class seats (at the expense of cheaper economy seats) in an attempt to increase the average fare and revenue yield of each flight. This has been partially successful.

At the same time ...
o Greater emphasis on service quality, especially punctuality and reliability, to try and establish customer loyalty. After all, expectations continue to rise despite the low fares.

o The introduction of frequent flyer promotions (free flights on particular airlines for regular travellers who accumulate points for miles). This is also aimed at generating more loyalty. The end result has been a potent mix of poor profits, leading to corporate failures, disgruntled employees who are either laid off or forced to accept pay cuts, and unhappy passengers who are affected by the inevitable overbooking as airlines try to ensure every plane flies full.

o The industry has exhibited one aspect of classic oligopoly behaviour with deregulation. When American Airlines tried to lead fares back up, it failed.

Perversely, at the same time, there is considerable regulation. The alliance between BA and American has become embroiled in the long running negotiations for an open-sky agreement between the UK and US, whereby individual airlines are allowed freer access to routes and airports. A proposal (in early 2000) for the acquisition of KLM by BA was immediately seized upon by the European Union competition regulators. Almost immediately it was suggested that BA and KLM would be required to divest their respective low-cost carriers, Go and Buzz. The later merger between Air France and KLM was permitted.

In 2008 four BA managers are standing trial, accused on collaborating with other airlines to fix the amounts being surcharged to cover the higher price of aviation fuel, triggered by the global upward trend in oil prices.

Question: Why, then, deregulate? Are governments too readily impressed by the seductive cost savings for passengers? Would some regulation be more sensible than full deregulation?