The Asian Journal of Shipping and Logistics ● Volume 25 Number 1 June 2009 pp.103-120 ●

Market Performance of Low-Cost Entry into the Airline Industry: A Case of Two Major Japanese Markets*

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Contents

Abstract

This is an empirical analysis of the dynamic changes in consumer surplus and industry profits after a low-cost carrier (LCC) enters markets, performed by estimating structural demand and price equations using unbalanced carrier-specific panel data of two to four carriers on nine routes for four to eight years (130 samples). Our findings are that gains in consumer surplus were substantial for as long as two years after market entry, but losses began in the third year, when two of the LCCs agreed on a code share with All Nippon Airways (ANA), a full-service carrier; since the third year, those carriers seem to have regained profitability. Our conclusion is that Japanese regulatory sectors, which have allowed full-service carriers other than ANA to engage in behavior that drives LCCs out of competitive markets while also allowing the code-shares between ANA and LCCs, seem to stand by the industry instead of consumers.

Key words: low-cost carrier, consumer surplus, industry's profit

* This paper was awarded STX Prize 2008.
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I. Introduction

Japan's domestic air markets have long been tightly regulated in entry-exit, price, and quality competition, even after a minor revision of the regulations in 1986. In 1972[1], the Ministry of Transport (MoT) granted to Japan Airlines (JAL), more than two-thirds of which was owned by the Japanese national government, the right to operate only in international markets and in thriving trunk routes in domestic markets. MoT also granted to All Nippon Airways (ANA) the right to operate not only in domestic trunk routes together with JAL but also in thriving local markets originating mainly in Tokyo (Haneda) and Osaka (Itami). Moreover, it granted Toa Domestic Airlines (TDA, later renamed Japan Air System, JAS, which then merged with JAL in 2004) the right to operate only in local domestic markets with low demand. In 1986, MoT permitted ANA and JAS to enter international markets and, conversely, JAL to enter domestic local markets in addition to trunk routes. MoT also privatized JAL in 1987. However, no new carriers were founded at that time.

In 1996, responding to the worldwide tide of deregulation, MoT allowed for the foundation of two carriers and let them enter domestic markets. One was Hokkaido International Airways (called Air Do, with the code ADO), which was founded by bankers and farm entrepreneurs in Hokkaido who had complained about expensive airfares. Their claim was that the three full-service carriers (JAL, ANA, and JAS) set very high prices through collusion and that these inflated fares were damaging the regional economies in Hokkaido, which were highly dependent on air transportation to and from the Tokyo area. The other was Skymark Airlines (its code is SKY), which was founded by a travel agency, HIS. HIS was motivated to create new demand for package tours by issuing much cheaper tickets than the full-service carriers did. In 1998, ADO and SKY entered the Tokyo-Sapporo and Tokyo-Fukuoka markets, respectively, which are the largest and second-largest city-pair routes in the world in terms of demand size. SKY also entered the Osaka-Sapporo and Osaka-Fukuoka markets.

In 2000, MoT deregulated airfares and entry/exit in domestic markets, and two other airlines were newly founded, Skynet Asia (SNA) and Star Flyer (SFJ). In 2002, SNA entered the Tokyo-Miyazaki market, followed by the Tokyo-Kumamoto and Tokyo-Nagasaki markets, which are long-distance city-pair routes with few surface transportation modes to compete with airlines. SFJ started operating in the Tokyo-Kitakyushu market[2] in 2006

1 This political decision is the so-called "45-47 regime" or "Aviation constitution", which was still in effect in 1986.

2 Kitakyushu, with its population above one million, is located in Fukuoka prefecture, but inconvenient access by public transportation prevents it from being a secondary airport to Fukuoka Airport.