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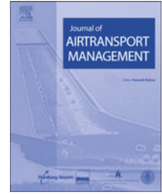

Legacy carriers fight back: Pricing and product differentiation in modern airline marketing

Tim Hazledine

Department of Economics, The University of Auckland, New Zealand

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ABSTRACT

The adoption of the low-cost carrier business model has applied competitive pressure on established network or "legacy" carriers, by offering fares at prices that legacy carriers find it difficult to match and still cover their fixed costs. This paper reports how two medium-sized national airlines-Air New Zealand and Air Canada-have coped with the low-cost threat by, in effect, turning their fixed costs into profit centres. Features such as full regional networks, long-haul connections, frequent flyer programs, membership in global alliances, lounges and business class cabins can be bundled into products which can be marketed and sold profitably to business and even some leisure travellers, and which cannot be easily replicated by low-cost carriers. Although not panaceas, the innovations of Air New Zealand and Air Canada to the competition they face in their domestic and trans-border markets demonstrate the possibility of an effective legacy carrier response to the low-cost carrier business model.

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1. Introduction

This paper examines how two full service national network carriers – Air New Zealand and Air Canada-have responded to two of the major challenges facing airlines in the 21st century: namely, the continued competitive threat from the low-cost carrier (LCC) business model, and the potentialities of the internet as an instrument for marketing and transacting air carrier services.

The analytical context is the "empty core" hypothesis (Button, 2004), to the effect that the large fixed costs incurred by "legacy" carriers make it difficult-perhaps impossible-for them to set prices adequate to cover all their costs without those prices being well above marginal variable costs, and therefore vulnerable to predatory marginal cost pricing by rivals, with this unstable situation presumably exacerbated when the rivals are low-cost carriers without large fixed costs of their own to cover because of their flexible, route profitability-based business model.

Some legacy carriers have responded to the LCC threat by stripping out their own fixed costs – either by in effect turning themselves into low-cost carriers on short-and medium haul routes (e.g. Aer Lingus), or by setting up LCC subsidiaries and deploying them as a "fighting-brand" on the leisure-oriented routes most susceptible to LCC competition (e.g. Qantas with its subsidiary Jetstar).[1]

In contrast, the strategies of Air New Zealand and Air Canada share a quite different response to the LCC business model. Instead of stripping out fixed costs, they turn them to their advantage. The basic idea of this paper is that legacy carriers' fixed costs can actually deliver market value; that this value can be enhanced by shrewd and innovative pricing and marketing practices, and that such practices cannot easily be replicated by LCCs and so can deliver a source of competitive advantage to the legacy carriers which may compensate for the LCCs' lower variable costs. These valuable "fixed" elements in Air New Zealand and Air Canada's product portfolios include their status as national carriers, the density and coverage of their domestic and international route structures, the penetration of their websites, their membership of global alliances, their FFPs, their lounges and other benefits for high-status travellers, and their business class cabins.

2. Background: market penetration of LCCs

Although the market penetration of low-cost carriers did increase quite rapidly over the past two decades, there may now be signs emerging of some sort of equilibrium, in which the overall market share of LCCs has stuck at numbers in the 20–40 percent range, depending on market structure. In the US, the LCC share of the domestic market, in terms of number of passengers increased from 4% in 1990 to 20% in 1999, and thence to 33% in 2008, but the share of the six largest legacy carriers was 63.3% in 1997 and 63.1% in 2005, so that it may be that much of increase in LCC penetration is due to the adoption of the LCC business model by most start-ups

E-mail address: t.hazledine@auckland.ac.nz.

[1] Air Canada ("Tango") and Air New Zealand ("Freedom Air") have both experimented with fighting-brand LCC subsidiaries, neither of which are still in operation.

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and other small airlines, rather than to a push-back of the positions of the major legacy suppliers.[2] Note too that legacy carriers fly longer routes, on average, and so their RPM (revenue passenger miles) share is substantially larger, and their overall revenue share would be larger still, since their fares tend to be higher than those of the LCCs.[3]

Now, it could be argued that holding onto to market share is not the point – what matters is the *cost* of so doing. A succession of studies, e.g. Dresner et al. (1996) and most recently Goolsbee and Syverson (2008), have documented the dramatic impact on legacy carrier prices on routes impacted by actual or even just increased probability of entry by LCCs; in particular Southwest. Market share defended by slashing prices when costs are not slashed will impact profitability, and may not be sustainable, as Tretheway (2004) has argued.

Nevertheless, the Big-6 (now Big-5) US legacy carriers have chosen to respond to LCC competition with lower prices rather than just by ceding market share, and we should not presume that they don't have their reasons for doing so. As for profitability – well, the airline industry in North America has somehow survived for decades with long-run rates of return apparently well below what would be consider acceptable in most other sectors. Aviation is a glamorous business, and it may be that the "normal" rate of return on capital is lower in this sector, as it seems to be in other inherently attractive "lifestyle" activities, such as movie production, wineries and even farming in general. The recent spate of Chapter 11 episodes besetting the legacy carriers may in part reflect cash flow problems generated by sharper competition in the marketplace, but probably also has something to do with what could be called the demographic implications of their situation, whereby the incumbents are stuck with a literal legacy of pension and health plan obligations incurred in easier days, as well as a relatively high-wage unionised wage structure.[4]

Berry and Jia (2009) carry out an extremely sophisticated analysis of air travel demand, supply, and profitability in 1999 and 2006, and find that only a quite small proportion – around 10%-of the observed reduction in legacy carriers' profits between the two years were apparently directly due to the expansion of LCCs over that period, with major factors being greater price sensitivity of customers and a systematic change in preferences towards direct (not connecting) flights. The higher demand price elasticities have been informally linked to greater consumer use of internet ticketing: Dana and Orlov (2009) provide direct evidence that increases in internet penetration can explain the dramatic increase in load factors observed in US markets from just 62%, on average, in 1993 to 80% in 2007.

Smaller domestic markets support fewer airlines. In Canada, the near-monopoly created by the folding of the failed CAIL into Air Canada has been challenged successfully by the LCC WestJet, which was launched in 1996 and now takes about 40% of the domestic market as well as some of the trans-border business. In Australia, the failure of Qantas's long-standing legacy rival Ansett, in 2001, permitted the recently arrived LCC Virgin Blue to expand quickly to take around one third of the domestic market – a figure which appears to be acceptable to both airlines and which has been quite stable.

In New Zealand, although the inhabitants apparently consume more air miles per capita than in any other country, the size of the market (over four million residents plus over two million annual tourists) has historically been able to support only one profitable carrier (the national incumbent Air New Zealand), despite which first Ansett, then Qantas and now Pacific (Virgin) Blue as well as Qantas have taken advantage of the totally Open Skies regulatory environment to offer domestic services on main trunk and important tourist routes. There are no official data, but Air New Zealand appears to offer more than two thirds of the seats on the routes on which it faces competition, and has a monopoly of the other, regional, routes.[5]

On the trans-Tasman flights of 3–4 h duration that link the main cities of Australia and New Zealand, the legacy incumbents Air New Zealand and Qantas have since 2002–03 faced competition from Pacific Blue and from Emirates Airlines (making use of 5th Freedom rights), but seem able to hold on to market shares of between 70% and 80% in most markets.

3. The LCC competitive threat: Air New Zealand's response

Although the most obvious competitive challenge posed by the more successful LCCs was the substantially lower price tags on their product, it was the nature of the product itself that may in the long-run have posed the biggest threat to the legacy business model. Indeed, Tretheway judges that:

> Perhaps the most important impact of the LCC business model on [legacy carriers] has been the introduction of low one-way fares. This has undermined the price discrimination ability of the [legacy carriers], and is the most important pricing development in [the] past 25 years. (2004, p. 5)

If the (re)introduction of "low" one-way fares (i.e., not full-fare, unrestricted products aimed at business travellers) is the most important development in a quarter century, this reflects the fact that it challenged what arguably was the most important pricing innovation twenty five years ago – namely, the introduction in the early 1980s by American Airlines of the advance purchase discounted return fare with its key Saturday night stayover (SNS) condition.

This brutally simple marketing ploy was of course a clever way of getting high willingness to pay business travellers to self select themselves away from low-WTP leisure customers, with the latter willing and often even keen to secure their ticket well in advance, and undeterred by the SNS condition because most leisure itineraries include a weekend away in any case.

The first legacy carrier to introduce a fully worked through response to the LCC business model[6] appears to have been Air New Zealand, who in December 2002 rolled out their new 'Express Fare' system. The Express system had the following features:

- The product was pared back, with business class seating taken out, and hot meals and bar service removed, on domestic routes;
- The previous large number of different fare types or buckets was simplified to three, differing mainly in their refundability

[2] These data are taken from tables analysing US Department of Transportation DB1A data, found on www.darinlee.net. The market share of the Big-6 (AA, Continental, Delta, NWA, United, US Airways) was boosted by the absorption of TWA by American in 2002 and of America West by US Airways after 2005.

[3] BTS data reported on their RITA website show the six largest legacy carriers holding 47% passenger share and a 58.5% RPM share, in the months up to October 2008, with the same statistics for the three largest LCCs (Southwest, AirTran, JetBlue) being 22.6 and 20.3%,. The discrepancy between these numbers and those reported above may be because the latter uses US Department of Transportation data which do not include all the smallest airlines.

[4] A referee has suggested that these legacies may create barriers to down-sizing, which in turn may help explain why the US legacy carriers have fought so hard to retain market share.

[5] Qantas has made no secret of its difficulties in earning profits from its domestic NZ operations. Most recently, the CEO of the airline was reported to have said 'Qantas came close last year [2008] to exiting the New Zealand domestic market because it was haemorrhaging money' [See http://www.stuff.co.nz/business/industries/2924832/Airlines-bleed-in-Tasman-route-scrap].

[6] For a good taxonomy of the differences between legacy and LCC business models, see Gillen and Gados (2008).

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