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# Outsourcing for competitive advantage: An examination of seven legacy airlines

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ABSTRACT

Although airlines are increasingly outsourcing to achieve competitiveness in ever more challenging business environments, this practice is not always successful and its theoretical justification has not been fully explored. The paper compares the extent to which a number of key resources and functions in a sample of major, legacy airlines have actually been outsourced with a theoretical appraisal based on the transaction cost economics framework. The findings show that the degree of outsourcing of these activities is not always what theory would predict to be advantageous.


## 1. Introduction

> Outsourcing is becoming the next critical business process airlines are addressing. (Lindegaard, 2004).

Over the last decade or so, the question of whether to outsource key activities or keep them in-house has become an increasingly urgent one for airlines. Against a background of globalization and intensifying competition, many major carriers are going through a process of de-integration as they contract-out large parts of their businesses to networks of suppliers in the search for greater efficiency and competitiveness Many airlines are thus becoming managers of networks of outside suppliers, deciding which parts of their operations to outsource and whether it is actually possible or advantageous to do so. In practice, the advantages of outsourcing are not always clear; contracting-out key elements of a business can be risky, difficult to implement and manage, and there have been instances where the hoped for advantages have not materialized (Rasheed and Gilley, 2005; Steensma and Corley, 2000, 2001).

A number of theoretical frameworks have been developed to examine the benefits that may derive from outsourcing. Here, we concentrate on one, transaction cost economics (TCE)[1] (Williamson, 1985, 1991). TCE is fundamentally concerned with the question of whether it is advantageous, in terms of cost, for transactions to occur within the hierarchy of an organization or externally in the open market. However, there have been a number of criticisms of the model. First, there is a lack of empirical evidence to support it. A number of industrial studies (Murray and Kotabe, 2005; Zhang and Reichgelt, 2006) have been unable to explain all "make or buy" decisions. Elsewhere, it was found that the recorded music industry did not have the structure that TCE would predict (Gander and Rieple, 2004); instead, context-specific factors such as organizational culture and the need to protect certain strategic resources from "contamination" by partners were more important in determining structure.

Another criticism is that TCE assumes an industry context that is stable and does not deal adequately with situations that are dynamic (Gulati, 1995; Zhang, 2006). Given that many airlines are currently increasingly the outsourcing of large parts of their businesses in an industry that is rapidly evolving and anything but stable, any discrepancy between what theory would predict to be advantageous and the actual structure that prevails within the sector would seem to be worth investigating.

## 2. The international airline industry

The passenger airline industry can be divided into several strategic groups based on scope, scale and type of operation. We focus here on major international, full-service, legacy (i.e. formed prior to the industry's deregulation that occurred throughout the 1980s) airlines that are broadly comparable in the customer segments they serve, as well as in their operational requirements, and can therefore be examined on a "like for like" basis.

Over the last 20–25 years, this sector has been characterized by poor financial performance, and returns that would be, according to the UK's Civil Aviation Authority (2006), "unsustainable" in most industries. Few operators have made adequate returns on capital and there have been several major cases of corporate

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[1] This is more commonly known as the "new institutional economics" in the economics literature.

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failure. The airline industry is generally less profitable than the wider economy and also its supplier industries such as aircraft manufacturing, airports, aircraft leasing, and catering. Historically, it has also been subject to government intervention; most legacy airlines, or "flag carriers", have at one time been either partially or wholly state owned and controlled or have enjoyed, in some way, a degree of government protection. Although this has generally lessened over the last two decades, in some countries these airlines are still to some extent protected from failure.

Since the late 1970s, the main strategic drivers in this sector, in addition to the rising incomes of potential customers have been industry liberalization as well as growing competition that has accompanied a world-wide lowering of economic and trade barriers. Legacy carriers have found their markets increasingly open to both international rivals and new entrants such as low-cost operators (Morrell, 2005). Similar forces have led to restructuring and a growth in outsourcing in other industries (Haberberg and Rieple, 2007) but, as Pilling (2002) has pointed out, this process seems to be happening rather later in the airline probably because airline operations are still influenced by government intervention. Moves to outsource are also counter-balanced, in theory at least, by the possibility that contracting-out what might be seen as safety-critical functions may be too risky to leave to partners over which a firm does not have direct hierarchical control.

## 3. Theoretical underpinnings of outsourcing

Historically, much of TCE theory has been concerned with why organizations exist. Today, it is used to consider where the boundaries of firms lie, and thus the factors that make specific organizations and their industries take a particular form (Williamson, 1991). Key questions for firms are whether they should buy their inputs on the open market, develop them in-house, or choose some intermediate or hybrid form such as a joint venture or strategic alliance (Zenger and Hesterly, 1997).

There are five principal dimensions of TCE theory. *Opportunism* is the potential risk of sequestration of key assets by outside suppliers. *Asset-specificity* refers to the degree to which an asset is valuable in the context of a specific transaction; this is relevant because of its interplay with opportunism. *Frequency of use* implies that transactions carried out only very infrequently do not need to be undertaken within an organization's hierarchy. *Bounded rationality* refers to the degree of difficulty in forming transactional contracts because of the limitations of managers' knowledge and perceptions. *Environmental uncertainty* increases the problems arising from bounded rationality. These five dimensions interact to predict whether an activity is most efficiently carried out in-house or outsourced.

Hybrid arrangements are increasingly common, particularly in biotechnology or pharmaceuticals firms where there is a need for high levels of innovation and technological development (Haberberg and Rieple, 2007). These arrangements allow firms to achieve low costs through economies of scale and scope from diversification, as well as to build specific assets such as dedicated cultures and knowledge that can be protected from being damaged by a larger, more dominant, player through separation (Gander et al., 2007).

Although TCE uses the term assets mainly in the sense of physical things, it can also refer to intangibles like brands and proprietary technologies as well as core competences and capabilities—things that an organization does exceptionally well. In the case of the airline industry, some of the most important assets may be know-how or other resources that cannot be traded directly but nevertheless are potential sources of risk if lost. These include competences in network coordination and customer service management; on the other hand, other key assets, such as landing slots, can be traded relatively easily.

Such resources are also a potential source of transaction costs. Specialized assets that are irrevocably committed outside the organization to a particular undertaking and which cannot easily be reallocated elsewhere are a potential source of costs because of the need for protection against the risk of hold-up from suppliers or co-stakeholders who may gain access to, or control over, them (Fill and Visser, 2000; Gadde and Snehota, 2000). The costs of protecting against the risks of opportunism are likely to be higher the more critical the asset, although they may be reduced by psycho-social factors such as trust, long-standing relationships or location in an open network that is knowledgeable about behaviour and reputations. Costs may also escalate beyond expectations due to misunderstood contract details, reduced performance standards, or the failure to achieve expected quality, a particular problem in a fast-changing environment (Lacity et al., 1995).

Thus, the picture that emerges of risks and costs set against the potential benefits of outsourcing is a complex one. Although costs may be saved through contracting-out as a result of factors such as economies of scale, low-cost locations, specialization, flexibility and the resulting competences that come from experience (Fill and Visser, 2000; Jennings, 2002) these costs may be increased by the need to protect against the risk of hold-up of valuable assets. In the airline industry, the relative weight of, or interplay between, the various mitigating factors are complicated further by a legacy of government intervention and regulation, particularly in the area of safety, as well as a rapidly changing and evolving industry context that is no longer national but global in scope. Assessing the relative costs or strategic benefits of outsourcing in the airline industry is therefore likely to be challenging. Nevertheless, TCE provides an attractive perspective for assessing the structural changes in airline industry in recent years, and while it is clear that the industry is moving towards a networked form, in which hierarchical control is no longer necessarily seen to be the best way of organizing industry structure, the issue of whether this has happened in line with predictive theory offers scope for enquiry.

## 4. The investigation

A sample of international legacy airlines is used to examine their outsourcing strategies in five key functional areas in order to to explore whether these functions are carried out within a hierarchical structure or outsourced in some way. This actual practice is then compared against what TCE theory would predict to be the most advantageous arrangement in each case. The sample is purposive; all are major, full-service international carriers that compete in a global industry. To get geographical coverage, we look at two airlines from North America (American Airlines, United Airlines), two from the Pacific Rim (Cathay Pacific, and Qantas), and three from Europe (France—KLM, SAS, British Airway).

The functions examined are critical airline activities, all of which have been the subject of considerable debate within the industry about the merits or otherwise of outsourcing them. These functions are plane acquisition and ownership, engineering and aircraft maintenance, customer sales and ticketing, in-flight catering and corporate identity and brand management. The data are taken from a wide range of secondary sources including industry surveys, academic and industry journals and the airlines' own corporate websites.