

# Distortions of airline revenues: why the network airline business model is broken

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## Abstract

This paper looks at the inherent flaws that have emerged in the business models that have been pursued by the major network airlines. The business model adopted by the low-cost carriers is more robust and has gradually undermined the ability of the network carriers to practice the price discrimination needed for them to recover their full costs. The full service network carriers still have a future but they will take a smaller market share. The paper points to a number of modifications that need to be made to the full service network carriers' business model if it is going to maximise this share.

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## 1. Introduction

As the new millennia dawned, it became clear that the business model of the network airlines was broken: it was no longer able to drive a revenue base which could cover the traditional cost base of these air carriers including an allowance for an adequate rate of return on invested capital. This has been articulated in [Hansson et al. \(2002\)](#).

The airline business model—essentially designed to take anyone from anywhere to everywhere, seamlessly—was a great innovation, but is no longer economically sustainable in its current form ([Hansson et al., 2002](#)).

Air Canada CEO Robert Milton has also echoed this sentiment:

At the heart of the problem is the business model which full service carriers—including Air Canada—have used to generate revenues for five decades.”<sup>1</sup>

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<sup>1</sup>“Speaking Notes for Mr. Robert Milton to the International Aviation Club of Washington”, 19 November 2002, available from Air Canada Investor Relations via [www.AirCanada.ca](http://www.AirCanada.ca).

While the problems with the ability of the network air carrier business model to cover its costs was well-known earlier, the tragic events of 11 September 2001 produced a shock to the industry which made the problem plain enough for all to see.

In the period from 1945 to then end of the 20th century, the world's airline industry built a remarkable product. A passenger almost anywhere in the world could purchase a ticket to seamlessly fly to almost any other part of the world. This remarkable feat did not require an industry structure consisting of a single global airline. Rather, it used a complex, but effective set of relationships among hundreds of individual air carriers. Individual airlines invested in internal systems, infrastructure and procedures to connect passengers within their own network, as well as to the networks of other airlines, including competitors. Industry standards and facilitation services provided by the International Civil Aviation Organisation (ICAO), the International Air Transport Association (IATA), SITA/ARINC and others, were critical and effective in providing the global standards and services (financial and technical) to make world-wide connectivity possible. Travellers enjoyed low transactions costs—a single call to one airline or travel agent would procure for them a ticket to anywhere, potentially using the services of many carriers, and allowing refundability, flexibility, and in a large number of cases, transferability. As plans changed, the traveller

could change to different flights of the same or other carriers. Travellers also enjoyed relatively hassle free travel experiences—at least relative to extreme difficulty of making connections on the passenger rail systems prevalent in the first part of the 20th century.<sup>2</sup>

In developing this network product, however, air carriers required costly systems and infrastructure to serve their passengers. The same infrastructure was used to serve all passengers. This included both those passengers needing the connectivity, as well as those passengers whose journeys were simple point-to-point itineraries. While never empirically examined, economists would say that there seemed to be economies of scope in providing air transportation services to the passengers with simple itineraries as well as to those passengers requiring connectivity services.<sup>3</sup> It was believed it would have been more expensive to build a separate set of air carriers to serve the simple itinerary passengers, than it was to provide the network product to consumers who only needed simple services.

Regardless of whether this assumption was correct or not, market conditions have changed. The demand for air transportation has been observed to grow at roughly double the rate of the growth in the general economy. This has resulted in an dramatic increase in the size of aggregate and individual aviation markets. As these markets grew, and as entry into air transportation markets was deregulated, a new breed of air carrier emerged. Southwest Airlines might be considered as the first carrier to develop a successful business model for this new type of carrier. It offered a very simple and therefore low-cost service targeted at passengers with simply itineraries. As a result, this carrier has grown and has joined the ranks of the largest air carriers in the US (and the world).

While Southwest was the first carrier with the new business model, Ryanair is perhaps the best example, as

it is most extreme in reducing costs and confining its services only to passengers with the simplest of journeys. For example, Ryanair currently does not provide any network connectivity services; it even does not allow its own passengers to purchase through tickets that connect to its other flights. Passengers with simple itineraries have less need of baggage and Ryanair strictly limits the amount of baggage and carry on items. Passengers with simple itineraries, do not need complementary meal services. Managing the inventory of seats available for sale is simpler when there is no need to consider the revenue impact of connecting passengers versus originating passengers. There are no interrupted trip expenses, etc.

The simple characteristics of its passengers needs and the services Ryanair chooses to offer, have allowed it to dramatically lower costs. The lower costs have allowed it to offer lower fares. Given the elastic nature of consumer demand for airline services, this stimulates market size and the revenue base. Ryanair's costs are so low that in spite of lower ticket prices, it has a wide margin between yield and unit cost. This, in turn, has given the carrier resiliency to weather the significant recent industry downturns. It might also be added that this business model also increases general transportation safety. Air transport has a very high safety record, and to the extent that low fares encourages travellers to use air transport rather than use automobiles, overall transportation safety rates are improved.

This business model, which I refer to as the low-cost carrier (LCC) business model,<sup>4</sup> has proven to be financially successful. By this, I do not mean that any carrier following an LCC model will be successful. Rather, I mean that the successful LCC carriers have financially outperformed the traditional network carriers with whom they compete. I refer to the business model of the traditional network carrier as the full service network carrier (FSNC) business model. The LCC carriers have achieved the highest market capitalisation of any passenger air carriers in the US (Southwest), Canada (WestJet) and the European Union (Ryanair).<sup>5</sup> (The relative profitability of the US and

<sup>2</sup>In many countries, separate rail carriers would provide service to link outlying communities to major cities. Their networks were not connected. Passengers wishing to travel beyond the major city had to fetch luggage and make their own arrangements to get to a separate terminal of the rail carrier with the beyond service. Typically, originating carrier could not sell the needed connecting ticket. Separate transactions were required for each leg of the journey. A traveller from Omaha to Boston would require time consuming, costly and hassle filled connections in both Chicago and New York, which stands in contrast to the type of connectivity air carriers offered.

<sup>3</sup>The issue of economies of scope has been examined by transportation economists, e.g., Gillen et al. (1990). However, they examined different types of scope economies, such as between passenger and freight service as well as between scheduled passenger and charter services. Data did not exist to allow investigation of economies of scope between services to passengers with simple itineraries and services to passengers requiring connectivity. Interestingly, the Gillen et al. study found only limited economies of scope between scheduled and charter services, a finding which is broadly consistent with the view in this paper that network carrier provision of high connectivity services to all passengers is sub-optimal.

<sup>4</sup>Other terms have been used to describe this business model, such as the value-based airline. I prefer the LCC label, as it gets to the heart of the issue—the carriers provide a product to their customers at lower cost. For some customers, this provides great value (more consumer surplus) than purchasing the FSNC product. It does not provided value, however, to those consumers who need the network carriers' higher level of service. I also wish to emphasise that this business model is a low cost model, rather than a low fare model. High cost carriers can offer low fares, but these are not sustainable, as many FSNCs are discovering.

<sup>5</sup>Ryanair variously has the highest or second highest market capitalisation of the European air carriers.

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