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Airlines within airlines: Assessing the vulnerabilities of mixing business models

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ABSTRACT

In this paper we examine two questions; what is it that makes some cases of airlines within airlines apparently successful while in many other cases it is just the opposite? And second, why would a carrier attempt such a strategy, is there a common set of circumstances or is each case unique? In the US, Canada and Europe a number of legacy carriers have sought to respond to LCC entry by creating an LCC within the legacy carriers; most have failed but some have succeeded, most notably in Australia and Germany. We first examine the evolution of the LCC business model and illustrate the different forms it takes today. Following this we provide a discussion of the underlying sources of cost advantage of the LCC and assess which sources are sustainable in the longer term. Finally we examine the conditions under which these apparent successes have occurred and look for common threads. We find market dominance, judicious network planning and co-ordination are necessary conditions for success.

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1. Introduction

In June 2008 United Airlines made the decision to shut down 'Ted' the airline within an airline it had started in an attempt to compete with the LCC sector in the US; Ted mainly served such tourist destinations as Las Vegas and Cancun, and lots of points in Florida, and was aimed at stopping Southwest in those markets. This venture followed the ill-fated Shuttle by United airline within an airline that was started in hopes of staving off Southwest's entry into the California market. Ted was the last of the US carriers to abandon this business model; others that had been discarded in the US included Shuttle by United, CALite (Continental), Metrojet (US Airways), Delta Express (Delta), Song (Delta). All had been put in place to compete with the low cost carrier business model (LCC) – Southwest, JetBlue and AirTran in most cases in specific markets. In Canada, Air Canada finally abandon Zip, an attempt to compete with Westjet in the latter's primary western Canadian markets. This after having previously had a try with Tango, which was more of a fighting brand designed to focus primarily on one carrier, Canada 3000.

Although best known in the airline industry as 'a firm within a firm' strategy, there are other industries, not many, that have also tried (unsuccessfully) to use this strategy generally targeted at a specific product or geographic market. A good example is the Saturn by GM which was and is a car company within a car company. The motivation for GM was to produce a car that could compete with foreign imports while GM would continue competing with other North American producers particularly in the North American market. Neither Saturn, nor GM for that matter, has been a success story with continual erosion of market share and spiralling losses.

There are numerous examples in North America that the airline within an airline business model does not work and a few examples in Europe but many fewer; an example is Hapag Lloyd Express, an LCC which despite appearing successful was folded back into the mother airline. But we also see apparent successes of the firm within firm approach such as Jetstar with Qantas and Tiger with Singapore and German Wings with Lufthansa. In this paper we explore two questions. What is it that makes these cases apparently successful while in many others it was just the opposite? And second, why would a carrier attempt such a strategy, is there a common set of circumstances or is each case unique?

In the following section we describe those factors that led to the adoption of the airline within an airline strategy. We include changes in the regulatory structure as well as the development of new technologies such as the Internet. Section 3 looks at the history of the low cost carrier and describes how the business model differs from legacy carriers; where the cost advantages lie. In Section 4 we ask why a firm (airline) would pursue a strategy of a firm within a firm; why can hotels seemingly pursue this strategy successfully while others cannot. Finally in Section 5 we explore what the future might look like and the potential successes of Tiger, Jetstar and German Wings. We also provide a summary and conclusions in this section.

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2. What changed to lead to such a strategy?

2.1. Deregulation

The first low cost carrier (LCC) appeared in the US in the early 1970s before deregulation in domestic aviation in 1978. The low cost evolution spread to Europe in the 1990s and is a more recent, but fast-growing development in Asia.[1] In the US, the states of California and Texas were large enough to support intrastate carriers. Western Pacific Airlines in California and Southwest Airlines in Texas operated as low cost–low fare unregulated carriers. These carriers provided the empirical justification that based the motive to deregulate the domestic market in the US. After US deregulation by Congress in 1978, new entrant LCC airlines emerged. A large number of carriers emerged with low fare, low frills or no frills, however many collapsed in a few years proving that low fares were not sufficient to succeed in the market (Taweelertkunthon, 2006). The airline People Express expanded aggressively using its low-fare, no frills concept. It over-extended itself during expansion and eventually began to incur massive losses, and survived only until full service carriers (FSC) began innovations, with hub and spoke systems (H&S), frequent flyer programs, and yield management. In 1987 Texas International acquired the airline.

After deregulation, most LCC entrants were not successful in establishing a niche market, and dropped out quickly after operating in a short period. The advantage of lower costs in many cases stemmed from low factor prices[2] rather than from superior business strategies. The strategy was not well understood; LCC business models were not studied thoroughly in the economics literature in the 1980s. However Southwest Airlines, the Dallas airline has been continuously profitable since the early 1970s, and is one of the two remaining. Their successful business model has been emulated by many aspiring airlines (Taweelertkunthon, 2006). Some unsuccessful network carriers have transformed to be successful LCC airlines by basing their strategy on the Southwest model. Ryanair has become the cost leader in Europe from using the strategy. In addition, AirTrans has become profitable by using both its established hub and spoke system with a point-to-point service. The model has been modified in different ways, for example JetBlue has appealed to higher-end business passengers with cabin upgrades, such as satellite TV and leather seats. In the UK, easyJet operates without a travel agent and is positioned to attract leisure and business traffic, by serving both primary and secondary airports in Europe.

In a regulated industry, there is little incentive to plan or identify successful markets or market failures, or keep costs under control and be responsive to consumer demands. When the airline industry was deregulated, there was a fundamental change in the way firms conducted business. Firms must be driven by market opportunities and financial needs, and not by regulatory considerations. Prices need to be based on cost, operations must be efficient, and consumer oriented niches must be exploited. Emerging competition from low fare carriers arose at this time, with lower ticket prices and higher frequency of service. Empirical cost drivers are significant, and during the transition period following deregulation, carriers adopted a diverse variety of strategies to improve productivity, reduce costs, and increase market share, involving both operations and volume based cost drivers (Banker & Johnston, 1993). The deregulated market allowed LCCs to pick up price-sensitive market share.

When planning, a carrier must consider both the demand and supply side. The demand side has two key features: price and market access. Fare sensitivity is widely understood and variability between customers, coupled with a detailed information base from computer reservations systems (CRS) has allowed extensive price discrimination to be possible. Knowledge of willingness to pay plus the airline practice of yield management means fares vary with time of day, week, year, and destination. Fare setting reflects the variety of travellers ranging from the business traveller with considerably less fare elasticity that the visiting friends and relatives (VFR) passenger with high fare elasticity. Within each generic passenger group there are varying degrees of sensitivity. Within the business category, there can be client or company paid, fare insensitive travellers to the self-employed fare sensitive traveller, to a time-constrained conference participant, who will search for the lowest fare possible given time constraints.

2.2. Targeting unsatisfied demand

LCCs became unique with the strategy that pursued potential passenger's "discretionary entertainment dollars" and not necessarily "travel dollars", that is, initially they were not luring passengers away from legacy carriers. Instead, they were targeting customers 'off the couch' – passengers looking to spend leisure dollars. Initially, LCC passengers were customers that would initially not have flown; they were a previously ignored market. LCCs, with lower fares for travel were able to target this untouched market and facilitate demand. Within this market, LCCs practice a form of yield management (but not nearly to the same extent as FSCs). LCCs may have three fare classes while FSCs can have ten or more. An array of fare discrimination reflects the broad range of willingness to pay (WTP) and the airlines' ability to distinguish and exploit these differences. A key difference is that legacy carriers have a complex array of products which lead to complex pricing practices while LCCs have simple products and hence simple pricing strategies.

2.3. Coalition of passenger groups was finally broken

The proportion of US travellers subject to price premiums has decreased due to increasing share of LCC traffic (Hofer, Windle, & Dresner, 2008). LCCs were able to modify passenger groups and create a new market segment. With heavily segmented customer groups, legacy carriers are no longer able to cover all customer and market segments with a single network model. They need to preserve core business with intercontinental connections and the required feeder platform, around which a variety of business segments can emerge. Success in segments must be competitive on a stand-alone basis, in terms of cost and quality. Cross subsidizing among segments (the old network paradigm) is no longer feasible.

In response to LCC threat, among many strategic competition challenges, an airline can adopt one of three strategies: (1) become a premium carrier, such as Emirates, (2) transform to a LCC, like Aer Lingus, or (3) become a superior network carrier, such as Qantas or Lufthansa. A premium strategy requires a lot of new expertise and transformation to an LCC demands a new company culture; both strategies require considerable investments at high risk. A more differentiated approach to key customer segments will make the biggest difference when an airline is faced with a failing strategy, since turning to premium and LCC strategies leads to considerable uncertainty. This suggests that spinning off an LCC is not optimum to restructuring the network, hence becoming a 'better' network carrier.[3] Qantas realigned its customer segmentation and

[1] The development in Asia is unique where the economics and aviation environment are unlike that of the US or the EU.

[2] This concept is explored in some detail later in the paper.

[3] For instance, Qantas, after experiencing falling yields like many other legacy carriers due to LCC growth, discovered their customers can be segmented into not only domestic versus intercontinental travellers and leisure versus business travellers but also into two additional dimensions: loyal versus opportunistic clients and outbound versus inbound clients.

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