

**Competing with Low Cost Carriers: Are regulatory barriers to entry
a strategy option for national flag carriers in Southeast Asia?**

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As ASEAN region low cost carriers expand their networks, the previously protected regional profits of the full service carriers are diminished. Market shocks place severe pressures on network carriers, and favour low cost carrier market entry. Periods of market recovery are typically marked by lower yields. New entrant pricing behaviour places further competitive pressure on full-service carriers, who have a range of offensive and defensive strategy options with which to respond. Pricing in the Kuala Lumpur – Bangkok market is considered.

Keywords

Strategy, ASEAN airlines, Low Cost Carriers, SARS

INTRODUCTION

National flag carriers in ASEAN countries are predominantly government owned, either directly or through stakes held by government investment corporations. Where partial privatisation of airlines in the region has taken place, strong links remain to national governments (Bowen 2000). Several, including Garuda Indonesia, Philippine and Malaysia Airlines, have faced major restructuring in recent years. Others such as Thai International have poor profit histories despite strong traffic flows and access to low cost labour. Historically governments in the region have given exclusive operating rights to national flag carriers, though some limited second tier carriers were operating in Thailand, the Philippines and Malaysia by 1997. Airlines have taken a key role in economic development in South East Asia, establishing technical capabilities, promoting tourism, and supporting international trade while providing basic transport links. Heavy investment in airport infrastructure has supported the development of hub and spoke airline networks as nations strive to gain an edge in tourism and air travel markets (Bowen 2000). Trading international traffic rights in bilateral air service agreements has been an important factor in managing the growth of these hub airports. Early attempts at deregulation in the region encouraged the emergence of new carriers following the low cost business model effectively implemented in the USA and Europe by new entrant carriers there. Differences in market size, geography, and airport access have created a different environment for the ASEAN based carriers and their full service (legacy) competitors from that in Europe.

INDUSTRIAL ORGANISATION THEORY

Industrial Organisation theory considers competitive strategy at an industry level. Porter (1980, 1990) argues that advantage is found by adopting one of a range of generic strategy positions from value based 'best cost' to attribute based 'differentiation', and that durable advantage is then sustained by defending the adopted position relentlessly within the industry's structure. Regardless of an individual company's performance, the overall profitability of its industry is shaped by a series of competitive forces and government actions. Where substitutes abound, consumers can switch easily, suppliers are powerful or barriers to entry and exit are low, an industry is likely to be relatively unprofitable.

Rivalry (expressed as price competition) emerges as a key factor in suppressing industry profitability, and Porter's model taken to its limits can be argued to propose that inter-firm collusion and the avoidance of price competition is the ideal business form. The airline industry's high capital requirements, protective regulatory structures, and scale advantages, should discourage new entrants, whose cost of entry would eliminate future profit streams. Opportunities in some ASEAN markets for cartel pricing and continued high barriers to entry should have provided high profits for the regions airlines, but state ownership and the desire by governments to develop strategic regional hub airports has led the industry to inefficient networks, ultimately suppressing profitability. (Bowen 2000).

Where competition is not focused on price and margins are good, new entrants can carve out a foothold by relying on the tolerance of large established players who are prepared to allow some incursion by start ups rather than compete on price and risk lowered profit margins. (Caves, Fortunato and Ghemawat 1984, Gimeno 1999).

This paper considers this the responses of established airlines in Malaysia and Thailand to the entry of a low cost competitor after market deregulation.

STRATEGY OPTIONS FOR LEGACY CARRIERS

Though the major routes in South East Asia appear to be open to competition, most city pairs have been served by the two national carriers, often with a codeshare¹ and revenue pooling agreement in place to share the revenue risk and effectively eliminate competition. D'Aveni (2002) identifies the gap between apparent intense competition, and the lesser reality of competition levels between airlines in the US market, as well as the tendency of the largest players in the market to exert pressure on the second tier players rather than compete head on with each other. As with Lawton (2003), D'Aveni identifies the need for proactive strategy settings when dealing with extreme competitive pressure or disruption in the airline industry, and illustrates the ability of upstarts to topple established major players in other industries, citing the fate of US retailer Sears whose powerful market position was overcome by new entrant retailers with a more cost effective business model (2002:44).

As entry barriers are lowered with the beginnings of deregulation of aviation in the ASEAN region, legacy carriers are facing competition in previously protected markets. Low cost carriers (LCCs) in the ASEAN region operate with some of the global industry's lowest costs (Saywell and Neuman 2003), and in the absence of secondary airports in most key cities² serve the same airports as the national flag carriers. Surface travel options are limited to Kuala Lumpur-Singapore where express buses offer a time-competitive option. Full service airlines can choose between offensive competitive responses, or seeking the restoration of defensive barriers to entry. Recent capacity decisions in the Indonesian market suggest that Garuda Indonesia will receive regulatory protection from further LCC entry in the near term. The failure of Singapore based Jetstar Asia to gain traffic rights to Shanghai, and Malaysia based Air Asia to gain rights to serve Singapore (even with a dedicated bus link over the causeway

¹ Codeshare is the process by which an airline holds out a flight number for sale on a service operated by another airline. For example - MAS and Thai International flights between Kuala Lumpur and Bangkok carry flight numbers for both airlines. Both flight numbers generally appear to travel agents on GDS screen displays, giving the appearance of a higher frequency of service for each airline.

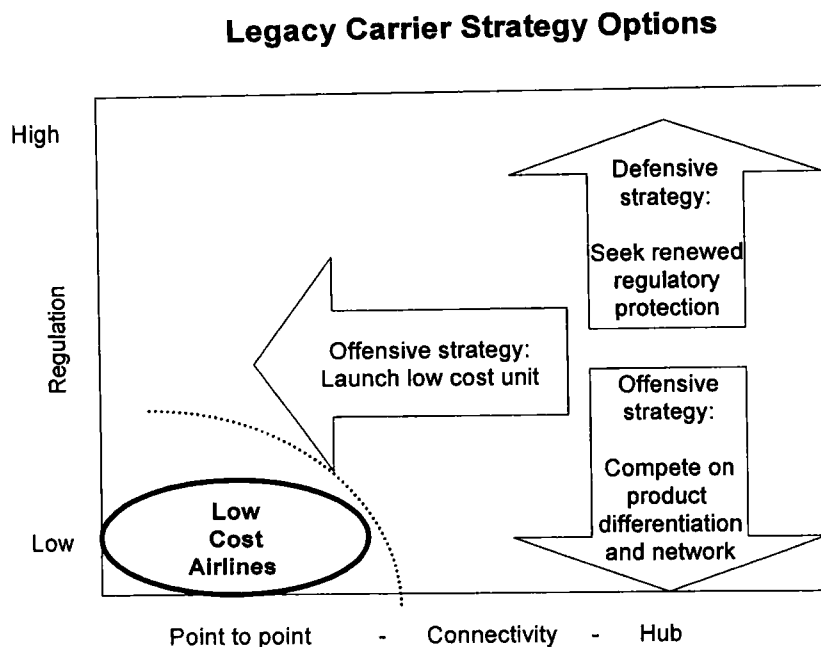
² Air Asia is operating to secondary Manila airport Clark Field, and serving Macau as an effective alternate to Hong Kong.

from Johore Baru) suggests that stalled deregulation will provide the most effective short term barrier to entry in the region.

The strategy options available to legacy full service carriers are:

1. Price-match and lower costs. A breakdown of LCC cost structures shows that fast aircraft turnaround, fleet commonality, and high seat density are major contributors to cost advantages. These are not readily replicated by legacy carriers attempting to retain hub and spoke networks with full service long haul products and mixed fleets.
2.
 - a) Clearly differentiate service standards and adopt a mix of premium/flexible and low/constrained fares to capture the extra value,
 - b) Launch a stand-alone low-cost subsidiary to tackle LCCs head-on in selected markets while maintaining full service network offerings. The model adopted by Singapore Airlines (Tiger) and Qantas (Jetstar/Jetstar-Asia).
3. Seek state protection through limiting traffic rights for LCC market entrants.

FIG 1.



Low Cost Carriers exploit market downturns

Legacy airlines usually retrench capacity to cope with market downturns. This was obvious during the SARS crisis, where affected carriers, bound by bilateral capacity regulations and

single hub network structures, had no flexibility to enter alternative markets to redeploy capacity. In the post September 11th 2001 traffic slump, low cost carriers in the relatively deregulated intra-Europe market were better able to weather the industry downturn than the legacy airlines (Lawton 2003) launching fare initiatives to support sales. The low cost carriers took the opportunity in the aftermath of the crisis to increase capacity and seize market share from the large flag carriers. Lawton (2003) observes that the successful carriers in Europe are those that focus distinctly on either on a low cost strategy (Ryanair, EasyJet) or on high end differentiated service. Of the differentiating carriers, British Airways (BA) is now achieving rates of return over 7% (Baker 2004), while carriers that tried to bridge both models, have been forced to change tack. Swiss International has returned to serving meals in its economy cabin, and Debonair having tried the high service low fare route has failed and left the market. (Lawton 2003).

Predictors of traffic growth

Airline traffic growth is positively linked to economic growth, with the potential for new entrant carriers to join a market highest when economic growth is strong (Gudmundsson & van Kranenburg 2002). An anecdotal '*rule of thumb*' in the airline industry is that traffic growth roughly doubles GDP growth (Tarry 2005). The 2004 growth rate in the US airline market was 1.94 times underlying GDP, suggesting a return to this 'rule' even in a period of relative instability in the industry, where most US major carriers were operating at a significant loss (Boles 2004). The degree of crisis for US Major carriers is demonstrated by the fact that while the low cost operator Southwest achieved a load factor 10 points above its breakeven, other major carriers (American, Delta, United, Northwest and Continental) were operating at load factors below breakeven, and revenues were growing more slowly than traffic, leading to yield reductions (Tarry 2005).

To test this rule of thumb, traffic volume measured in Revenue Passenger Kilometres (RPKs), sourced from airline industry publication Air Transport World, were gathered for US Major

carriers³, which represent almost 90% of US operated traffic and over 30% of traffic worldwide. Chart 1 shows US real GDP plotted against RPK growth and predicted RPKs that should have been generated if the rule of thumb applied. Since 1996, traffic volumes have shown much greater volatility than GDP, and have lagged GDP growth rates.

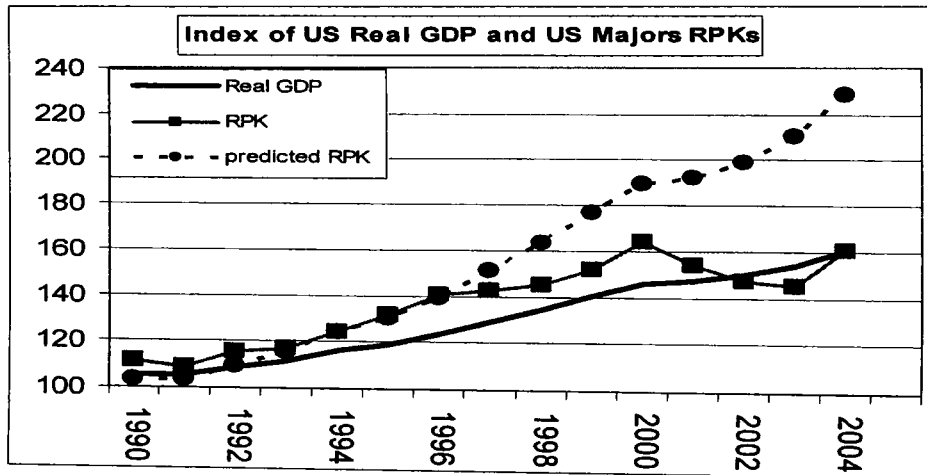


CHART 1.

The Gulf War of 1991 was the first major shock for the deregulating industry. Many of the recent shocks have occurred in Asia, from the economic crisis of 1997 to the SARS outbreak (Chin Hooper and Oum 1999, Min 2005). Declines in traffic from events like this are unsurprising, but the permanent loss of the business is interesting. Rather than recover lost volume when traffic growth returns, air travel appears to resume its long term growth pattern from the new base point. The impact of the shocks and downturns is therefore the permanent loss of that traffic growth to the industry as the impacted air journeys are not postponed but cancelled. Moreover, the recovery in traffic tends to be driven by deeply discounted pricing, further exacerbating the revenue shortfall and driving yield declines.

Since the US market was deregulated in 1978 (Robertson and Ward 1983) there has been a long period of competitive activity in that market, with carriers facing low barriers to enter or

³ The ranks of the US Major Carriers have changed over the course of time as bankruptcies and amalgamations have shifted capacity between airlines. In 1993 the group comprised American, America West, Continental, Delta, Northwest, Southwest, TWA, United, US Air and 2 freight carriers who generated no RPK's. These carriers generated almost 90% of US operated air traffic. By 2001 the list had added Alaska Airlines, American Trans Air, and American's regional operator American Eagle. The majors group continued to generate just short of 90% of all US operated air traffic. TWA has subsequently merged into American Airlines.

leave market segments. Low cost carrier Southwest airlines has operated throughout the period of deregulation, following a business model that relies on short point to point flights, lower fares, and limited in-flight service. To deal with the changed competitive environment, full service (legacy) airlines moved to compete more aggressively on capacity, network scope and at times price, often adopting or expanding a hub and spoke model to aggregate demand and maximise frequency (Nero 1999, Adler 2000, Franke 2004). The capital-intensive and network structured form of the legacy airlines makes it difficult for the companies to deal with sharp shocks to the operating environment and the subsequent downturns in traffic. Hub and spoke network operators also struggle to compete with new market entrants offering low fare direct flights on a portion of their operating route structure. Airlines have some motivation to continue to operate within the 1940's regulatory structure, recognising that there are benefits from industry co-ordination and from higher barriers to entry, (Richards 2001). Government negotiations of capacity and the interface between public and private institutions provide an environment for cartel-like behaviours in airline pricing, and for slow reactions to change.

ACTIVITY IN THE MALAYSIA – THAILAND MARKET

Prior to the SARS crisis, the Kuala Lumpur (KUL) – Bangkok (BKK) and Kuala Lumpur - Phuket (HKT) routes were operated in a tight regulatory environment with high barriers to entry. Only the two national carriers served the market, collaborating using code-shared and pooled operations to share risk and profits. In the SARS downturn Malaysia Airlines reduced capacity, withdrawing completely from the Phuket market. Air Asia's opportunistic entry to this market in the aftermath of the SARS crisis provides an opportunity to observe legacy carrier pricing responses to LCC activity.

Methodology:-

Lowest available airfares were collected from airline and ticket wholesaler websites for Malaysian, Air Asia, and Thai International. Off-peak future travel dates (30-60 days from

departure) were applied in fare searches to capture the lowest fares on offer⁴. Air Asia's website displays the lowest fare available for any date. Full service carriers offer fares in several booking classes, from the lowest available to unrestricted fares for the specific flights chosen. Airfares for comparison were selected exclusive of airport taxes and fees.

Observations

In early 2004, the lowest round trip fare (on inclusive tour packages from KUL to BKK) was over MYR730 (\$US190). Air Asia entered the routes with low introductory fares, and now sells at round trip prices between MYR160 – MYR480 (\$US 42-126). With its extremely low cost structure, fares as low as \$US70 round trip still generate yields above Air Asia's published break even costs. The legacy carriers chose to compete on price, and now sell round trip fares as low as MYR450⁵ (\$US118) while also carrying connecting traffic through their hubs and attempting to capture premium fares from First and Business class travel. New price competition for the previously high yielding local traffic places a heavy downward pressure on the yields of the legacy operators, rendering the markets much less profitable.

The ability of value based airlines to form commercial linkages with long-haul full service carriers is limited by low cost carrier business model. Direct to customer distribution techniques and the lack of flight connection services at airports exclude this market segment. (Piga and Filippi 2002). This leaves a number of markets, including Australia, with asymmetrical competition, having full service operators working alongside a value based carrier, with limited competitive overlap. In Southeast Asia, the lack of connectivity for inbound tourists forces the low cost carriers to focus on local and regional point to point traffic. This market segment was historically the best yielding for legacy airlines but is put at risk by adopting price-cutting rather than differentiation as the strategic response to LCC entry.

⁴ Malaysia Airlines lowest web fares are notionally restricted to sale in Malaysia

⁵ Source: Malaysia Airlines online bookings

IMPLICATIONS FOR THE INDUSTRY

In all regions of the world, the emergence of low cost carriers has been facilitated by some deregulation of previously tightly controlled aviation markets. From the USA in 1978 domestic and regional markets have been deregulated in Europe, Australasia, Europe and now South East Asia. This deregulation has lowered barriers to market entry, and has encouraged new entrants in all regions, though not always with financial success. The European experience (Pender and Baum 2000) saw a competitive response from legacy carriers including Aer Lingus and British Midland (bmiBaby) to restructure as low cost carriers. British Airways in contrast launched and subsequently onsold its low cost subsidiary (Go), determining to focus on recasting its own fares and network structure in Europe in a competitive differentiated form.

Given the layers of bilateral relationships, disturbance of the status quo of legacy carriers in Southeast Asia is most likely to come from new entrants rather than competition between the existing operators. New entrants in this region almost always follow a version of the low cost business model, and this is certainly the case for Air Asia, Tiger, and Jetstar Asia.

Adopting the defensive approach through sustaining barriers to entry for LCC's can only buy a short reprieve for legacy airlines. Experience has now demonstrated that the LCCs will respond rapidly to retrenchment of capacity in regional markets during any downturn, and this is borne out by the Kuala Lumpur-Phuket experience with Air Asia. Carriers that have successfully managed LCC competition have done so with a combination of focus on product differentiation, cost control, and most critically, the exploitation of the hub connecting market segment that the LCCs cannot serve. The long-term success of LCC subsidiaries of legacy carriers remains to be tested in the marketplace.

Traditional legacy airline reliance on network relationships between industry partners needs to be leveraged as a competitive advantage to support this differentiation strategy. Hub networks provide legacy carriers with capabilities that LCCs cannot readily imitate, and these can be leveraged to their strategic advantage in the international market. This new level of competition forces both an external adaptation to changing environments and an internal adaptation to changing managerial skills (Eisenhardt and Galunic 2000, Madhok and Phene 2001). Seeking to avoid these changes leaves ASEAN legacy carriers less able to compete in the broader international aviation market.

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