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Price rivalry in airline markets: a study of a successful strategy of a network carrier against a low-cost carrier

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ABSTRACT

In the post-liberalization period, competition has increased in airline markets. In this context, network carriers have two alternative strategies to compete with low-cost carriers. First, they may establish a low-cost subsidiary. Second, they may try to reduce costs using the main brand. This paper examines a successful strategy of the first type implemented by Iberia in the Spanish domestic market. Our analysis of data and the estimation of a pricing equation show that Iberia has been able to charge lower prices than rivals with its low-cost subsidiary. The pricing policy of the Spanish network carrier has been particularly aggressive on less dense routes and shorter routes.

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1. Introduction

The liberalization of air transport markets in the USA, Europe, and other countries has led to an increase in airline competition on several routes. This increased competition has been spurred particularly by the success of low-cost airlines.[2]

In Europe, low-cost airlines such as Ryanair, easyJet, and many others have become major players on short-haul routes. But while the biggest low-cost carriers (LCCs), namely Ryanair and easyJet, are performing quite well in competition with network carriers, it is not so clear whether smaller LCCs are really able to compete with former flag carriers. In fact, a number of former flag carriers have created low-cost subsidiaries to increase their cost competitiveness on short-haul routes by offering point-to-point services in competition with other LCCs. Recent examples of this strategy in Europe are provided by KLM with Transavia, Lufthansa with Germanwings, and SAS with Snowflakes. In some other cases, former flag carriers have set up a subsidiary to externalize their European air services and then cutting costs even without achieving the low-cost model. For example, some of Air France's European flights are operated by its full subsidiary CityJet that is registered in Ireland.

In this paper, we analyse Iberia's implementation of this strategy in Spain with the creation of Clickair to compete with the Spanish LCC, Vueling. In 2006 Iberia, the former Spanish flag carrier, initiated a new business plan that led to the concentration of its operations at its main hub, the airport of Madrid-Barajas. A further measure in this plan was to create a new low-cost airline, Clickair, with an operating base located in the airport of Barcelona-El Prat. Madrid and Barcelona airports are both among the 10 largest airports in Europe in terms of the passenger traffic they handle.

Using Iberia's slots and resources, Clickair soon acquired the largest market share at Barcelona airport. One of the most probable motives for the creation of Clickair was to compete with another Spanish low-cost airline, Vueling, which had become a serious competitor to Iberia in the Spanish domestic market.[3] In 2009, Clickair and Vueling merged under the name of Vueling. In this new company, Iberia is the major shareholder.

Our empirical analysis, therefore, focuses on a case in which a network airline successfully competed with another low-cost airline through the operating of a low-cost subsidiary. This paper examines Iberia's successful strategy by analyzing price rivalry on Spanish domestic routes departing from Barcelona airport. We use data from the period 2003 to 2009.

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[2] However, competition has not always become the rule. In Europe, liberalization also led to an increase in new, monopolistic light density routes (Dobruszkes, 2009b). In this regard, low-cost airlines may be competing with network carriers in some routes but they have also focused on niche markets.

[3] A further possible motivation for the creation of Clickair was Iberia's desire to impose an entry barrier on other network carriers like Lufthansa or Air France, should they have wanted to develop hub-and-spoke operations at a large airport, such as Barcelona, close to Madrid. With a big LCC like Clickair, the profitability of the spokes (the short-haul flights meant to feed long-haul flights) might be affected. Any discussion of this additional motivation lies beyond the scope of this paper.

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The aim of this paper is twofold. First, we seek to identify the type of routes that benefit most from the price rivalry established between Clickair and Vueling, examining route characteristics that include traffic density and distance as well as airline attributes such as their respective market shares. Second, we wish to assess whether Iberia's successful strategy is associated with predatory behaviour.

The remainder of the paper is organized as follows. In Section 2, we review the literature most closely related to this study. In Section 3, we describe the data used in our empirical analysis. In Section 4, we examine in detail the statistics describing price rivalry in the Spanish market. In Section 5, we estimate equations at the route level to explain the determinants of both mean prices and the prices of Iberia (and its partners) in relation to its rivals. The last section is devoted to concluding remarks.

2. Literature review

One of the most obvious effects of the liberalization of the airline industry has been the decrease in airfares due to increased competition (Button et al., 1998; Goetz and Vowles, 2009). In this regard, the relationship between airfares and competition has received a great deal of attention in the empirical literature on air transportation.

Since the seminal paper of Borenstein (1989), several studies have examined the influence of market characteristics such as route concentration or airport dominance on airline fares. Applying the pricing equation, the success of LCCs as new entrants has been particularly well documented in the USA. In this market, Southwest has become the airline with the largest market share. Several papers have documented that legacy carriers cut fares on those routes affected by the actual or potential entry of Southwest. Among these studies, mention should be made of those by Dresner et al. (1996), Morrison (2001), and Vowles (2000, 2006). From these studies, it seems clear that the entry of an LCC, most notably Southwest, on a route leads in general to a reduction in mean prices at that route level.

The effects of the success of LCCs in Europe have also been analysed using a pricing equation.[4] Alderighi et al. (2004), Fageda and Fernández-Villadangos (2009) and Gaggero and Piga (2010), respectively examine the effect of the presence of low-cost carriers operating on routes in Italy, Spain and United Kingdom on prices. As in the US case, they similarly report that prices on a route are lower when an LCC starts its operations there.

To date, there has been very little attention dedicated to the circumstances under which a legacy carrier (or a network airline)[5] might charge lower prices than its low-cost rivals once the latter have entered the route.

It is clear that LCCs are able to exploit several cost advantages on short-haul routes (Graham and Vowles, 2006; Francis et al., 2006). First, low-cost airlines are able to achieve a high utilization of the plane and its crew. Second, they have lower labour costs due to the weaker role played by the unions. Third, they have a simpler management model. This is attributable to the fact that they focus on point-to-point services, use just one type of plane, operate a single fare class, and provide no free on-board frills. Some LCCs, such as Southwest and Ryanair, also enjoy lower charges from their use of secondary airports.

In this regard, Graham and Vowles (2006) identify two alternative strategies that might permit network carriers to compete with LCCs. First, network carriers can establish low-cost subsidiaries in what the authors call the "carriers within carriers strategy". The main airline and its subsidiary may complement or compete with each other. For example, it seems that Go was competing with its owner British Airways but Iberia is not competing with its subsidiaries in Spain. Second, network carriers can seek to reduce costs by competing against LCCs with their main brand. These strategies might be aimed at responding to the actual entry of an LCC or pre-empting its possible entry.

In this context, there is an increasing convergence of the business models being operated by network airlines and LCCs on short-haul routes. For example, most network airlines provide no-frill services on short-haul routes and are gradually eliminating the business fare class on certain routes or simplifying their yield management system. In many cases, they are also establishing franchises with regional airlines that use smaller aircraft. However, it is more difficult for network airlines to reduce their labour costs or to simplify certain aspects of their management systems, such as their distribution practices. For these latter reasons, it might make sense for a network airline to compete with LCCs that have lower operating costs by establishing a low-cost subsidiary that fully adopts the low-cost model.

However, Graham and Vowles (2006) undertake a broad examination of the establishment of low-cost subsidiaries by network carriers around the world but fail to find indisputable evidence that this strategy has been successful. In an analysis focused solely on the US experience, Morrell (2005) draws the same conclusion.

It would appear that the difficulties in effectively separating network operations from those of the low-cost subsidiary lead to a cannibalization and dilution of the main brand. Furthermore, network carriers may find it difficult to differentiate the pay scales of employees due to union activism.

Nevertheless, the successful establishment of low-cost subsidiaries by network carriers could be associated with predatory behaviour. In this regard, Goetz (2002) reports several complaints made by new entrants about the predatory behaviour of incumbent airlines in the US domestic market in the 1990s. Such behaviour typically saw incumbent airlines cutting fares to similar or lower levels than those of their new rivals and increasing flight frequencies. In such periods of price rivalry, the larger incumbent airline may well lose money, but once the new entrant has been forced to exit the market it can increase prices and reduce flight frequencies.[6] While predatory behaviour is prohibited by most of Competition Laws in the world, Goetz (2002) documents a number of cases, including that of American Airlines following the entry of Vanguard Airlines on routes departing from Dallas–Forth Worth airport. Eckert and West (2006) describe a case in which Lufthansa was held to have been guilty of predatory behaviour in competition with a charter airline, Germania, on routes from Frankfurt and Berlin.

However, the difficulties encountered by antitrust authorities in distinguishing predatory behaviour from sound price competition means that incumbent airlines are quite likely to adopt such behaviour. Indeed, the predatory behaviour of incumbents is a key issue when investigating competition in the airline market.

3. Data

Below we describe the data used in our empirical analysis which is based on the estimation of pricing equations. As we will explain, we consider both mean prices and price differentials

[4] See Dobruszkes (2009a) for a recent analysis of the geography of LCCs in Europe.

[5] We prefer to use the term network airline because it is a more general term. A legacy carrier, in the United States, is an airline that had established interstate routes by the time of the Airline Deregulation Act of 1978. European airlines that had a monopoly in their respective country before liberalization were called flag carriers.

[6] As Motta, 2004 points out: "yet, although rare, there are circumstances where a dominant firm might set low prices with an anti-competitive goal: forcing a rival out of the industry or pre-empting a potential entrant". This provides a good definition of predatory behaviour.

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