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Competitive strategies in Australia's airline deregulation experience

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I. INTRODUCTION

Australia's domestic airline markets became deregulated on November 1, 1990. A sole new entrant, Compass Airlines, first flew passengers a month later. A little over one year later, Compass was grounded by its creditors, on December 19, 1991. Compass management (and much of public opinion) blamed the Government, and the Government (and the incumbent airlines) blamed Compass management, for the opportunities lost. But all parties probably now agree that there have been important lessons learned for the benefit of the new era of airline competition that is now beginning.

This paper first considers events which occurred preceding deregulation which had major impact on the competitiveness of Compass Airlines.[1] It subsequently outlines the vigorous price competition of 1991 and the increase in service quality that was fostered by the more competitve environment. After considering the theory of the optimal competitive strategy, the paper then examines the demise of Compass Airlines in terms of management's failure to single-mindedly pursue its optimal strategy. It concludes that despite the allegedly inappropriate actions and inactions of the Government, its agencies, and the rival airlines, Compass failed because it failed to define and pursue without distraction a clearly-articulated competitive strategy. In particular, Compass pursued suboptimal pricing strategies.

II. SIGNIFICANT EVENTS ON THE EVE OF DEREGULATION

The culmination of the deregulation debate was the announcement on October 31, 1987 that regulation of Australia's airline markets was to end three years later, such notice being required by law. Even prior to this, deregulation was foreseen by most industry observers, and the incumbent airlines took several significant steps to strengthen their competitive position prior to the commencement of deregulation.

Pre-deregulation Mergers and Takeover Activity

Both major incumbents engaged in takeover and merger activity in the years prior to deregulation to consolidate their networks and feeder systems. Ansett Airlines acquired East-West Airlines in July 1987, in what the Bureau of Transport and Communication Economics (BTCE) regards as the first strategic response to imminent deregulation.[2] Australian Airlines acquired Eastern Australian, Sunstate Mildura and Sunstate Queensland airlines. Continuing into 1991, Ansett established Ansett Express and Australian launched Australian Airlink.[3]

Both Ansett and Australian took the opportunity to build an airline system that would be more robust under the more-competitive conditions anticipated under deregulation. Drawing on deregulation experience in North America, the incumbents saw that regionals would feed traffic into the parent airline's capital city 'hubs' for uplifting on routes not served by the regional, and conversely, would allow the parent airline to offer customers a wider range of rural and holiday destinations without having to fly larger aircraft into those airports. East-West was positioned as a one-class 'holiday' airline and concentrated on serving the leisure market into Coolangatta and other holiday destinations, as well as serving as a regional into the major city hubs. Not insignificantly, this positioning allowed East-West to be a 'fighting brand' for Ansett against any entrant that chose to serve the leisure market rather than make a full frontal attack in the major 'business' markets of the eastern corridor. Similarly, the ownership of all but two of the significant regional airlines by the incumbents probably inhibited the entry of a significant new rival as a regional carrier.

The Gates Agreement

Bryan Grey, Chairman of Compass Airlines, whose credits include Executive Director (Policy) for Ansett, Owner-manager of East-West Airlines, and General Manager of Air Nuigini, began planning his entry to a deregulated market as early as 1986. His plans were thrown into confusion, however, by the agreement between the Government and the incumbent airlines that Ansett and Australian would effectively have a 30 year lease on all airport 'gates' (both existing and to be built in the future) with the exception of one or two gates in each terminal that were to be made available to new entrants at reasonable lease rates.

This restriction on gate availability not only limited the feasible number of new entrants to a maximum of two, but ensured that any new entrant would have great difficulty in scheduling aircraft arrivals, departures, and passenger transfers. As perhaps the worst example of the consequent difficulties, Compass finally agreed, under duress and just prior to beginning service, to use two gates in the Australian Airlines terminal at Sydney airport. Unfortunately, these gates were non-contiguous and the lease rate was excessive.[4] This was better than Ansett's Melbourne airport offer, where the two gates were 1.5km apart! In Adelaide, Compass operated from a hastily painted hangar, (dubbed a "tin shed" by the media) due to the lack of available terminal facilities. In Perth, Compass operated from the international terminal, kilometres from the domestic terminal and intrastate connections, and passenger loadings were initially delayed by a requirement that all luggage must be hand searched. An x-ray machine was later provided.

In preparation for deregulation, the Federal Airports Corporation (FAC) was established to take over (from the Federal Government) the ownership of, and responsibility for, the efficient operation of Australia's major airports. It is highly significant that the gates agreement between the Government and the two major airlines was finalised on the evening of December 31, 1987, the day before the FAC began operation. Thus, the incoming Director of the FAC was faced with a *fait accompli* that substantially lessened his flexibility to provide new entrants with adequate terminal facilities.[5]

The Gates agreement forced Compass to re-think their aircraft choice. Initial thinking had been to utilise smaller aircraft with more-frequent scheduling to more airports. Planning shifted to the larger Boeing 767, and these planes were to be serviced at Qantas facilities. A contract to this effect was to be signed when the Federal Government directed Qantas not to deal with any new domestic airline. Servicing arrangements were then made with Hawker-Pacific, who was the agent for Airbus, so the aircraft choice became the considerably larger Airbus A300-600R aircraft, with less frequent schedules and fewer airports to be served. The higher breakeven volume on the larger planes meant that Compass either had to win a larger share of the existing market at similar prices, or expand the market more with deeper discounts, or a combination of the two.

The Pilots' Strike

The third significant pre-deregulation setback for Compass Airlines arose as a consequence of the abortive Pilots' Strike of 1989. Fearing that deregulation would be accompanied by salary rollbacks and pilot layoffs, as had occurred in the US situation, the pilots union called a nationwide strike that lasted five months. The impact on business and tourism was claimed to be severe, although discerning observers noted that the deepening recession and the record travel levels associated with the Bicentennial Celebrations and the Brisbane World Exposition in 1988 had caused many travellers to stay at home in 1989 in any case.

Immediately, the Government provided Hercules troop transports to move stranded passengers, and permitted international airlines to carry passengers between Australian cities. While this was no doubt the appropriate Governmental response, it certainly served to decrease the pilots' momentum and helped the airlines break the strike. As the strike dragged on, the airlines gradually increased their ability to move passengers by hiring new pilots. Then, in a brilliant tactical manoeuvre, the airlines began proceedings simultaneously against every striking pilot under section 45D of the Trade Practices Act (whereby an employee can be sued if he/she causes loss to the employer by industrial action). This forced the pilots to choose between returning to work or resigning to protect their personal assets. Their *en masse* resignation was no doubt greeted with great triumph in the Ansett and Australian boardrooms!

1,647 pilots resigned and only about half were ultimately re-employed, allowing the incumbent airlines to restructure their operating budgets, both in terms of average pilot salaries, pilot workloads, and the number of pilots on their payrolls. Thus, a substantial part of the cost advantage that Compass had initially expected to have over the incumbent airlines was removed by the major strategic blunder of the Pilots' union. Alternatively, this might reasonably be interpreted as another strategic victory for the incumbents on the eve of deregulation.

Ownership of Computer Reservation Systems and Travel Agents

Ansett and Australian jointly established Southern Cross Distribution Systems which owns the 'Galileo' Computer Reservation System (CRS), used by 1,407 travel agents. Apparently unable to gain access to this system on agreeable terms, Compass signed on with the 'Fantasia' system (based on the American Airlines 'Sabre' system) being promoted by Qantas, and used by 1,308 travel agents.[6] Compass subsequently suffered because of the technical difficulties in establishing the link between the Fantasia and Galileo systems. Travel agents who did not separately access Fantasia were unable to show Compass last-seat availability. The Trade Practices Commission has recently cleared the merger of the 'Fantasia' system with the Galileo system, for a single Australia-wide CRS.[7]

In a flurry of acquisition activity, the major incumbents also moved to gain ownership and control of major chains of travel agents. Ansett acquired the Traveland chain of agencies and joined forces with Coles-Myer to form another sales network. In August 1990, Coles-Myer-Ansett Travel purchased the ANZ Bank's 40-outlet travel business. In September 1990, Australian purchased the 42-outlet Westpac Travel Services. Since domestic travellers utilise travel agents to book about 50-55% of all domestic flights, the ownership of these agents might have been expected to confer benefits on the parent airline company. After the demise of Compass, however, the Trade Practices Commission found no "indications that the established airlines had used in a predatory or anti-competitive way their ownership of (the Galileo CRS), their links with travel agents, or their...business lounges and frequent flyer clubs".[8]

Ansett and Australian also formed strategic alliances with international, regional and commuter airlines, and with hotels, car rental agencies, and travel agencies. Being first in, they tied up the larger and more popular providers, such as Avis and Hertz, leaving Compass to ultimately make a deal with the weaker Budget Car Rental chain, and with other firms in the travel and hospitality industries.[9]

III THE FIRST YEAR OF DEREGULATION

It is important to note that the first year of deregulation occurred during a severe recession. Based on the previous recession, it is estimated that passenger volume would have fallen by 20-30% during 1991, in the absence of reduced airfares. Instead, passenger volume quickly surpassed the previous-record year of 1988 and by September 1991 was 37% above 1988 levels, despite the recession and due almost entirely to the vigorous price competition following the entry of Compass Airlines.[10] Revenue-Passenger-Kilometres flown in the year ended September 1991 were 45% greater (at 16.1 billion) than RPKs in the preceding year.[11]

In October 1990, prior to the onset of deregulation, the incumbent firms leapt into action, provoked by the opening of bookings for Compass flights. East-West Airlines offered mild discounts, provoking matching price reductions by the two majors on the same routes. Simultaneously, Ansett and Australian launched into a non-price battle for the business flyer, upgrading their cabins and stressing the features of their members-only clubs at the major airports.

Compass entered the market on December 1, and faced many problems in the first months. Aircraft deliveries were delayed, requiring flight cancellations and rescheduling. Aircraft were delivered with what were considered to be inferior seats but had to be used to convey passengers prior to being refitted up to the standard of the "best economy class in Australia" claimed by Compass. The impact of these problems on early word-of-mouth endorsements was inevitably negative. Moreover, early bookings were doubtless lost when Compass telephone lines were jammed by a telephone-dialing computer, apparently by a prankster, although the possibility of 'dirty tricks' by the incumbents could not be ruled out.

From the beginning, Compass airfares were to be set 20% below rival economy fares (50% below on curfew flights). As an example, the Sydney-Melbourne one-way fare on the incumbent airlines was $229, and the Compass fare would be $184. Bryan Grey emphasised that these lower fares were due to the lower operating costs associated with a single type of aircraft, the fuel efficiency of the Airbus, and leaner corporate structure. In an apparent attempt to avoid direct confrontation with the incumbents, he stressed that he would expand the market rather than steal customers from the incumbents, and that he was not competing for the business or first class markets. Instead he would provide affordable one-class air transportation that would induce people to fly for the first time and to fly more often. But the addition of the Compass Airbus 300 aircraft to the domestic market served to increase airline capacity significantly. Given such excess capacity at the standard airfares, a price war was inevitable.[12]

The Price War

In January 1991, a traditionally slow season for the airlines, Ansett initiated a network-wide "January Seat Sale" with discounts of 47-61% which Compass and Australian matched within days. On the major airlines, these fares were available only for January and February. Other conditions attached to the Ansett and Australian fares were later simplified in reaction to the relative lack of conditions on the Compass fares. Then followed a three month ceasefire.

On May 3, Compass introduced its "Recession Buster" fares at 70% discount on 20 seats per flight. On May 9th, Australian matched with its "Best Fares" campaign, and the next day Compass extended the fares to 50 seats on each flight. Ansett and Australian then launched give-away promotions offering overseas and resort vacations. In mid-June Compass offered two-for-one sales across its entire network, followed by Australian's "Seat Sale" with 65% discounts on selected routes. Ansett matched, Compass later undercut, and both majors then matched Compass. During June, one-way fares on the Sydney-Melbourne route fell from $100 to $85.

This skirmish continued into July, with Ansett extending its 55-70% discounts to 156 routes in total (both Compass and non-Compass routes.) Australian then cut $10 off fares from other state capitals into Adelaide a week before Compass began serving Adelaide on July 15, 1991. Ansett matched these fares, and Compass, operating from terminal facilities in a tin shed,[13] undercut by a further $10. At this time it also became obvious that foreign airlines, such Fiji's Air Pacific, were cutting their fares and package prices in an attempt to win back their share of the domestic tourist dollar. Similarly, State rail and coach companies were cancelling services and reducing fares as they felt the brunt of intermodal substitution.[14]

Compass, with only three aircraft, was credited with flying 21.3% of total passengers on the routes it flew in the second quarter, and 10.6% overall, almost doubling its market share from the previous quarter. Ansett's share was 40.4% overall (41% in previous quarter), Australian 36.7% (39%) and East-West 4.6% (6.2%). Australian explained its market share loss primarily in terms of the Perth routes, on which Compass had made major gains. East-West subsequently withdrew from five regional airports and increased flights into the major holiday gateways. Both Ansett and Australian had strengthened their regional and commuter airline ties by this time.[15]

All airlines reported major losses for the first six months of 1991. The Ansett Transport group (including East-West) lost $200m over 1990-91, and foreshadowed losses for 1991-92. Staff cutbacks amounted to over 200 since deregulation began, and in September East-West announced the retrenchment of a further 233 employees. Australian Airlines lost $12m in the first six months of 1991, and had made redundant over 1,000 employees, with more job losses foreshadowed.[16] Compass declared a first-year loss of $10.3m, later adjusted to $16.5 million, compared to its prediction of a $20m profit for 1991-92.

In late July the Melbourne-Perth fares fell from $150 to $125 each way, in a skirmish initiated by Australian and quickly matched by Compass and then Ansett. In August 1991, Compass introduced its bulk-purchase deep-discount "Freedom Fares" aimed at serving corporate travel requirements. Although non-refundable, these tickets were transferable and valid at any time until July 1992. On August 25, Ansett and Australian simultaneously (and hastily) launched their Frequent Flyer programs, and offered flight bonuses on flights flown in September. On September 3, Compass, eschewing frequent flyer programs, launched a three-for-one ticket offer (which effectively cut the Sydney-Melbourne fare to $62) available for three-weeks, and the next day offered on a permanent basis booklets of tickets at deep discounts in a major effort to capture a greater share of the business travel market.[17]

A cross-section regression analysis explaining the lowest available discount fare in the June-August price war found that fares were positively related to route length, negatively related to number of competitors, and negatively related to the presence of a dummy variable indicating that Compass also flew on that route.[18] These results indicate that price competition increased even on routes which Compass did not contest, although a separate study indicates that prices typically fell by less, or did not fall, on routes not contested by Compass.[19]

Over the third quarter of 1991, Australian had surged to the front of the more-lucrative business travel market, with a 43.2% share, followed by Ansett with 33.5% and Compass with 8.7%.[20] This represents a significant gain for Compass (up from 5.3%) and a major loss of share for Ansett (down from 40.1%) despite their having gone from three-abreast to two-abreast business class seats, and their major expenditures on its frequent flier program and airport clubs.[21] The gains achieved by Compass in the business travel market might have as much to do with the recession as anything, as Compass continued to pursue a "one-class" service, although "suits" were routinely allocated seats in the forward section of the aircraft.

On October 3, Ansett and Australian initiated a further round of fare reductions. Two days later, Compass retaliated with a "seven-day price blitz" with the lowest unrestricted fares ever offered (e.g. $75 Sydney-Melbourne and $148 Sydney-Perth) and was immediately matched by Australian and Ansett. East-West cut its "daylight saver" fares by 50%. Australian and Ansett then launched "Spring Sales" for flights until the end of November. Compass retaliated with lower fares usable until the end of December. The two majors then extended their use-by dates to June 1992. Also in October, Compass doubled the commission to travel agents to 20% on full fare tickets, four times the rate allowed by the other airlines, and raised the commission on discount tickets from 9% to 12.5%.[22]

In November and December Compass was offering $100 *return flights* between most eastern capital cities. Ansett responded with a "Pre-Christmas" offer of $69 each way. Compass responded with another three-for-one offer that was 67% below the incumbents' economy fare. It is significant that the 'Available Seat Capacity' of all airlines was 40% greater in October 1991 as compared to the previous October.[23]

In late November Bryan Grey was selected 'Business Leader of the Year' by *Business Review Weekly* for his services to the outstanding success of deregulation and the rejuvenation of domestic tourism.[24] In another victory reported in the business press that month, Compass won a $25m settlement from Airbus Industrie relating to the August delivery of an aircraft that was due in May. Payment was not expected until mid-1992. Compass was also pressing for immediate payment of about $5m from Australian for 'overcharging' for terminal facilities.

On December 9, Bryan Grey announced Compass would introduce a 'Corporate Class,' representing a major reversal of his "one-class" philosophy. Finally acknowledging that they were suffering from their inability to penetrate the more-lucrative business class segment, Compass curiously limited the availability of these fares to businesses with an annual travel account of more than $10,000. In the same statement, Grey lamented the "crazy" prices of his competitors and virtually accused them of predatory pricing on some routes (presumably Perth) while raising prices on other routes.[25]

On December 18, 1991, representatives of Polaris Holdings attempted to re-possess a Compass aircraft for non-payment of fees. The same day, Compass officials were reported to be unsuccessfully seeking from the Minister of Aviation an $18m sale of tickets for Government employees, to avoid loss of the aircraft. The next day, the CAA placed statutory liens on the aircraft for $12m in unpaid landing fees, fearing they would otherwise leave the country. This action stranded 8,000 Compass passengers per day during the Christmas peak travel period, and most of these were accommodated by the other airlines and Qantas.[26]

Vigorous debate followed in Parliament and in the media. Compass employees marched through city streets, raising $5 million in donations. Bryan Grey searched for a corporate white knight, while blaming the Government for the demise. The Minister for Aviation was most vocal on the part of the Government, and placed the blame squarely on Compass management. The Trade Practices Commision was charged with investigating circumstances behind the failure of Compass, and a provisional liquidator was appointed. At the time of writing it is expected that Southern Cross Airlines, one of the potential entrants in 1990, will successfully float a public subscription of stock and purchase remaining Compass assets, employ about 60% of Compass staff, and begin flying smaller (McDonnell Douglas MD80) aircraft under the Compass logo by August or September 1992.

IV. THE OPTIMAL COMPETITIVE STRATEGY FOR COMPASS AIRLINES

A new entrant to any market must carefully consider the strategic options open to it and select an appropriate competitive strategy. It must then make all management and marketing decisions *such that they best serve* the firm's chosen competitive strategy. Before considering the record of Compass management in this context, it is instructive to first consider the appropriate competitive strategy for Compass in the circumstances confronting it.

Following Porter [1980], firms may adopt either a cost-leadership or a differentiation strategy. Cost leadership means, in essence, that the firm attempts to widen its price-cost margin by giving primary attention to production efficiencies and other means of reducing costs. Alternatively, a differentiation strategy attempts to widen the price-cost margin by giving primary attention to the quality of the product or service, such that the firm better serves the client's needs. Such differentiation inevitably increases unit costs, but it is done with the expectation that prices may be increased by a larger proportion.

For a new entrant, the choice between cost-leadership or differentiation depends on three major issues, First, the competitive strategies of the existing firms should be carefully evaluated. It is obviously wiser to avoid head-on confrontation with an existing firm that already has a strong cost or differentiation advantage. Second, the incumbent firms' ability to respond to the entrant's selected strategy should be carefully evaluated. A low-cost entrant should not be vulnerable to high-cost incumbents unless the latter have substantial cash reserves. Similarly, a cashed-up incumbent might find it very easy to match or exceed the entrant's quality offers.

A third major determinant of the appropriate competitive strategy for a new entrant, suggested by the economics of information literature, is the cost of information regarding product quality. Nelson [1970] introduced the 'search' versus 'experience' goods distinction, based on the cost of customer information regarding product quality. Consumers determine the quality of a search good at relatively low cost prior to its purchase and consumption. Conversely, the quality claims of experience goods cannot be evaluated until after consumption.

In the case of airline travel, consumers gain information about all major aspects of service quality at relatively low cost, simply by asking a travel agent or calling the airline's toll-free telephone number. Similarly, extraordinary performances regarding punctuality, lost baggage, and consumer complaints are typically reported in the press or conveyed by word-of-mouth, particularly if there are any significant discrepancies across firms. Violations of safety regulations, near misses, and crashes, receive front-page press coverage. Thus, information on most aspects of product quality is available to consumers either costlessly or at minimal cost.[27]

Since consumers have nearly costless access to full information concerning the quality of all competing flights on the route they wish to fly, airlines must expect a relatively elastic demand increase to follow either a price reduction or a quality increase that remains unmatched by its rivals. Oppositely, firms should expect a significant loss of market share if a rival either reduces its price, or increases its quality, other things being equal. These relatively high price and quality elasticities of demand are due to the ability of the consumer to compare the services offered by the competing airlines with a high degree of certainty and consequently select the carrier that offers the best value for money.[28]

The availability of (virtually) full information on the product's quality attributes thus places direct pressure on any firm whose product is considered inferior in one or more of these quality dimensions. That firm is induced to raise quality to the prevailing standard in all dimensions. If this is impossible to accomplish immediately, a compensating price reduction is necessary to avoid loss of market share, as fully-informed consumers would prefer the greater value implicit in equally-priced but higher-quality service available elsewhere. But since the profit-maximizing markup on unit costs is relatively low in markets that exhibit relatively high price elasticities of demand, the scope for price reductions without subsequent losses is limited.[29] Thus, the firm is likely to have a profit incentive to raise its quality attributes to the prevailing standard set by the other firms. It will typically do this by instituting quality-control systems and management practices similar to those in effect at the other firms. Quality advantages inherently related to the aircraft used are also copied as soon as possible, with orders for new aircraft models typically being placed almost simultaneously by all major airlines.

Although advertising stressing quality characteristics (such as punctuality, inflight service, and convenient departure times) is indeed observed, such claims are typically made only when they are a distinguishing feature of that airline's service. For the most part, claims of differentiation can be verified by the consumer prior to purchase. The quality features that are true, and result in increased traffic, will be emulated quickly by the other firms. The claims that are disputable will cast doubt on the credibility of the firm's other quality claims. As a consequence we see a preponderance of advertising that is primarily informative, stressing price and quality features like new routes, direct flights, more-convenient departure times, and the like. It follows that non-price competition (stressing a particular quality attribute) is typically a short term strategy designed to take advantage of the firm's essentially temporary advantage in that dimension.

A corollary of the above is that airline advertising is primarily oriented to the print media, rather than to television. The print media have the comparative advantage in transmitting large quantities of specific information that can be referred to repetitively by the consumer, whereas television has the comparative advantage in transmitting persuasive messages that involve imagery, exotic scenes, and celebrity endorsements. Further, the marginal revenue productivity of repetitive informative messages is likely to decline sharply, as the message is redundant to those who already know, and it is increasingly difficult to reach people who have not yet heard it. Because television time is relatively expensive, because TV advertisements are relatively time consuming and expensive to produce, and because there is limited scope for economies of repeated use of the advertisement, we should expect to see airlines limiting their TV advertising to brand-name enhancement, claims for quality advantages, and the announcement of major pricing adjustments that apply system wide. It follows that the advertising elasticity of demand for airline transportation, and for search goods in general, will tend to be relatively low.

The profit-maximizing rule for the simultaneous adjustment of prices and advertising requires that the proportion of sales revenue spent on advertising be equal to the ratio of advertising elasticity of demand to the price elasticity of demand.[30] I have argued here that the price elasticity of demand for airline transportation will tend to be relatively high, while the advertising elasticity of demand will tend to be relatively low. Thus a relatively low budget for advertising (as a proportion of sales) is to be expected for the airline firms in particular and for firms selling search goods in general. US observation bears this out: the advertising/sales ratios of airlines are substantially lower than for beverages, for example, the latter being experience goods.[31]

Thus, a strong emphasis on price competition in the airline passenger market can be seen as the profit-maximising response to the relatively high price elasticity of demand for the product in conjunction with the relatively low advertising elasticity of demand. The relative magnitudes of these elasticities in turn derive from the consumer's ability to verify quality claims prior to purchase. Although airline executives may wish to escape the unrelenting pressure of continuing price competition in their markets, they are continually drawn back to it as the most effective means of increasing their load factors, market shares, profitability, and indeed, their chances of survival.

While the airline industry is a good example of the long-term correspondence between search goods and the optimality of the cost-leadership strategy, airlines nonetheless have a strong profit incentive to exploit any temporary quality advantages, and to introduce innovations in the various dimensions of quality. Thus, while firms may pursue differentiation strategies in the short run (particularly for the business traveller,) in the long run they will return to the cost-leadership strategy as the most effective means of achieving superior profitability, assuming no collusion among firms.

There are two major caveats to this. First, business (and first-class) travellers have markedly less elastic demand compared to leisure travellers. This is primarily due to the much lower income elasticity of demand that accompanies greater personal wealth and/or the use of non-personal wealth to pay for the ticket. This means that price competition for business travellers is not especially productive, and price reductions may even reduce total revenues. The fact that most business travel is at short-notice and/or requires flexible itineraries allows airlines to discriminate against business travellers in their pricing policies. But they are nonetheless discerning buyers and expect value for money, and thus the competitive arena shifts to quality issues, given similar business class fares. Thus competition for business travellers will proceed on the basis of differentation unless the supplier cannot make any credible claim of superiority in any major quality dimension. Persuasive advertising is likely to be more effective for business travellers, and for inducing business travellers to try business class, whereas informative advertising is typically more effective for leisure travellers.

The second caveat concerns first-time flyers, for whom flying is an experience good. They typically do not know what to expect, nor which questions to ask. Even when supplied with information, this may have little impact, as its relevance may be unclear to them. As with most experience goods, first time users must be tempted to give the product a trial before they will 'know' what the product or service is. Accordingly, persuasive advertising may be more productive with first timers than would be informative advertising. Similarly, deep discounts may be used to induce trial, and indeed may well be the most cost-effective means of inducing trial and thus informing the first time flyer of the service quality, given the low marginal cost of supply. Another means of inducing trial would be to bundle flights with holiday accommodation and ground tours, such that the overall price represents a real bargain, and major benefits are offered that can form the basis for persuasive advertising.[32]

V. THE STRATEGIC MANAGEMENT OF COMPASS AIRLINES

In their prospectus Compass argued that their costs per seat kilometre would be only about 60% of the incumbents' and that they would set their fares significantly below the incumbents' economy fares. Thus they appear to have consciously adopted a cost-leadership strategy, secure in the knowledge that thirty-eight years of regulation had permitted the incumbents to build up substantial X-inefficiency.[33] But several of the subsequent Compass decisions do not seem to be in keeping with the single-minded pursuit of a cost-leadership strategy.

Management Mistake #1: Choice of Aircraft and Fitout

The first problem with the aircraft selected was that they were more expensive than necessary for a firm pursuing a cost-leadership strategy. The choice of Airbus appears opportunistic rather than well considered. Following the failure to obtain Qantas agreement to service Boeing

767s, Compass appears to have let the choice of aircraft be dictated by the willingness of Hawker-Pacific to service their aircraft. Accordingly, they chose an aircraft that, while fuel efficient if fully loaded, nonetheless was relatively expensive to lease and fly if projected load factors did not materialise.[34] At a time when there were hundreds of planes idle worldwide, it seems unlikely that more economical and smaller aircraft were unavailable. It also seems unlikely that all other aircraft servicing companies in Australia would have been unwilling to service Boeing or McDonnell-Douglas aircraft, for example. Even if Hawker-Pacific were the only feasible service facility, were there not older and smaller Airbus aircraft initially available?[35]

A second problem with the aircraft was that they were of higher quality than necessary for a firm pursuing cost-leadership strategy. Wide-bodied aircraft attract a premium, as do more youthful aircraft. Keeping in mind that aircraft safety can be virtually assured by the mandatory inspection procedures required of all airlines, the most that Compass needed to do in strict pursuit of a cost-leadership strategy was to match the quality of the aircraft being flown by the incumbents.

A third problem was the expensive refitting of the Airbus A300-600R aircraft after their arrival in Australia with 288 higher-quality seats in eight-across configuration, in place of 360 'hard' seats in nine-across configuration. With only 288 seats, seat pitch (legroom) was 86cm, the same as in the incumbents' Business class. Compass also introduced inflight video to Australian travellers. Compass then claimed the best economy class in Australia.[36] Refitting four aircraft in this way not only cost millions, but appears to have been a strategic error. Had the aircraft been supplied in that configuration, Compass might well have crowed about the better seats and legroom, but refitting the cabins to a standard higher than its rivals appears to have been a costly diversion from its strategy of cost-leadership.

A fourth problem with the aircraft was that they were too large. Bryan Grey stated many times that the limited availability of terminal facilities induced him to choose larger aircraft. But larger planes also take longer to turn around, as loading and unloading times increase commensurately. With twice as many smaller aircraft, for example, Compass would have sacrificed some economies of aircraft size, but would have been able to offer better flight frequency, widely regarded as the key to success in the airline business.

Management Mistake #2: Overestimation of Demand

Given the Gates constraint, and the choice of aircraft, Compass apparently chose its seat configuration on the basis of its estimates of demand. Compass managers expected that airfares 20% below the incumbents' full economy fares (50% below on curfew flights) would expand the market sufficiently to fill their large aircraft. Thus Compass appears to have overestimated the price elasticity of demand for air transportation. Alternatively, Compass failed to predict the severity of the recession, and/or their spreadsheet planning did not include sensitivity analysis to alert them to the impact on demand of a severe recession. Air transportation is highly income elastic for both the leisure traveller and for business travel (when viewed by the chief accountant rather than by the employee travelling at employer expense).

Management Mistake #3: Underestimation of Rivals.

Compass seems to have failed to predict that incumbent firms would match its lower fares and be prepared to accept severe losses in an attempt to hold market share. Early statements by Bryan Grey indicate that he did not expect the rivals to match lower prices because of their cost disadvantages. He repeatedly claimed that the lower fares would serve to expand the market and that he did not expect the major firms to lose passenger volume. Indeed, their passenger volume did increase, but they seemed strongly motivated by their relative market shares, as if it were an indicator of which firm was best coping with the rigors of deregulation. It seems that Compass confused the long run impossibility of rivals' pricing below full cost with the short run strategy of their pricing below full cost in the hope of outlasting the new entrant's limited finances.

Management Mistake #4: One-class Service

When risking shareholder funds in a competitive market, management has the responsibility to maximise the firm's profit (over some consensual horizon) in that market. Price discrimination increases profitability in airline markets because the three requirements for its feasibility are easily met. First, in general, price elasticity of demand differs between business travellers and leisure travellers. Second, these two segments are, by and large, separable by the imposition of restrictive booking conditions, such as requirements for advance booking and Saturday night stopovers. Third, price discrimination requires the absence of vigorous price competition within in each market segment. Tacit agreement that discount fares be largely confined to the leisure segment, while competition for the business traveller proceeds on the basis of quality features, is common in airline markets elsewhere, and would have been a natural outcome here.

The single-class configuration of Compass aircraft was claimed as a cost-saving feature avoiding the expense of more lavish food and beverage services en route, as well as additional terminal services. Without airport Club Lounges like the incumbent airlines, Compass would have had to offer a compensating price differential (that is, cheaper business class fares) but the additional service costs are surely less than the price premium that can be extracted from the business flyer. By eschewing a business class cabin, Compass locked itself into a vulnerable situation whereby the major airlines could cross-subsidise discount fares in economy class with higher prices from their business class passengers.

It seems more likely that the underlying reason for a single-class airline was Bryan Grey's personal philosophy of egalitarianism, and his judgement that most people would happily fly economy class, particularly if it was the "best economy class" in Australia. Thus, the decision to refit the cabins at a higher standard, and the decision to go one-class were apparently intertwined. As noted earlier, Compass had been seating business travellers ("suits") in the front of the aircraft since about mid-year and formally announced in December that they would begin operating a 'Corporate Class' in the near future.

Management Mistake #5: Insufficient Yield Management

Yield management involves limiting the sale of discounted fares on a particular flight to those seats that are expected to otherwise remain empty. Utilising price discrimination principles, deep discounts should only be allowed for advanced bookings or for last minute (standby) loading of passengers who take the place of no-shows. This practice ensures that each flight maximises revenue generated.

Compass consistently offered discounted fares without usage restrictions or with lesser restrictions than applied to the fares of rivals. Ticketholders were allowed to make flight bookings (using tickets previously purchased) at short notice and/or at peak travel times when many of them would have been willing to pay more. Because many of these tickets were initially purchased at deeply discounted rates (through sales of ticket booklets, bulk purchases, or two- and three-for-one sales), Compass in effect forfeited the additional revenue that it might have captured.This led to a downward spiral, in effect. Load factors were relatively high but cash inflow was relatively low because many passengers were flying on tickets purchased months before. Given the lack of anyone willing to provide new debt or equity funding, Compass was forced to reduce fares still further to induce a new round of cash inflows.

In their attempt to practice yield management, Compass was hamstrung by an inadequate reservations program that allowed only five different ticket classes. One of these classes was reserved for stockholders, leaving only four separate ticket classes to be utilised for yeild management, which was insufficient to handle the variety of different fare categories an airline would need in a sophisticated yeild management system. Given the ten years of yield management experience in the US airline markets, the failure of Compass management to implement a better yield management system must be seen as a major contributor to their demise. The TPC Report indicates that a sophisticated yield management system was to have been acquired in 1992.[37]

VI. Summary and Conclusions

It is too easy to take the view that the current Federal Goverment has little enthusiasm for airline competition, and is directly responsible for the demise of Compass Airlines. Granted, the Gates agreement defies explanation in terms of the public benefit, and the Government did help break the Pilots' strike, allowing both Ansett and Australian to reduce their staffing costs dramatically just prior to the beginning of deregulation. Also, Government employees were not encouraged to utilise the services of Compass, and Government agencies (the TPC and the PSA) did not appear too sympathetic when fielding complaints about the actions of incumbent airlines'.

But even given this wall of adversity, Compass could have survived and prospered, were it not for a series of strategic management mistakes. It failed to clearly articulate a cost-leadership strategy (for its targeted leisure travellers) and to ensure that all subsequent decisions directly supported that strategy. It chose an expensive aircraft that was better than necessary for a firm pursuing a cost-leadership strategy in that target market. It refitted these planes with "the best economy class in Australia" sending mixed signals to its target market. Compass appears to have overestimated the price elasticity of demand for air travel, and to have underestimated the management prowess of the incumbent firms. But perhaps most importantly, Compass erroneously adopted a one-class cabin configuration, ignoring the profit and cross-subsidisation opportunities afforded by price discrimination against the business traveller. Finally, Compass failed to implement an adequate system of yield management, such that much of the potential income that it might have earned from both business and leisure travellers was left as unclaimed consumer surplus.

Has deregulation been a success so far? Indeed, with the exception of airline stockholders and Compass ticket holders, most parties have benefited from deregulation. Average fares (across all classes of tickets) declined by 31.7% from September 1990 to December 1991.[38] All indicators of service quality have improved or not declined. Frequency of service increased by 21% overall on the top 40 routes, including routes not contested by Compass. Load factors have been nearly constant or declined. Non-stop services have increased slightly, with no evidence of hub and spoke networks forming. On-time performance has improved at the main airports. In-cabin and ground services have generally improved. Finally, safety standards have not been adversely affected.[39]

What lessons have been learned? The government has learned that they lose political support unless they act positively to make airline competition possible. The public has learned that deeply discounted airfares cannot be expected at short notice and in peak periods. The incumbent airlines have learned that they must compete on the basis of price for a large segment of the market. Potential entrants have learned that incumbent airlines have competent management and will 'play hardball' to protect their market shares and stockholder investment.

What opportunities were lost? Losses include the alternate uses of $65m invested by Compass stockholders and the $38m tied up in unused Compass tickets (both of which may be partly recoverable eventually), the unprecedented operating losses by all airlines during 1991, the productivity gains by the incumbents that would have been gained had competition from new entrants been sustained, and the improvement of the national transportation network that vigorous route competition would have delivered.

What can we expect in the next phase of airline deregulation? Prime Minister Keating has belatedly announced that new airport facilities will be built to provide gates for future new entrants, and that Qantas and Air New Zealand will be allowed to fly domestic passengers between Australian airports. Qantas has now 'bought' Australian Airlines and the combined entity is to be privatised, most likely with substantial equity interest from an international airline. Mergers between regional, national and international airlines are an increasing probability. Southern Cross Airlines is currently readying to fly under the Compass logo in August or September, 1992, and so the battle will begin again.

FOOTNOTES

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1 For discussion of Australia's 'Two Airline Policy' and the debate prior to deregulation, see Poulton.[1981]

2 *Deregulation of Domestic Aviation: The First Year*, BTCE Report 73, November 1991.

3 All such mergers or acquisitions must be 'blessed' by the Trade Practices Commission, which has the power to prevent acquisitions that it considers will significantly reduce competition.

4 The lease rate was disputed by lawsuit, which eventually Compass won in late 1991, but Australian immediately appealed to a higher court, delaying the $4.9 million payout in Compass' hour of greatest need.

5 One might well ask why the Government would agree to terms that would clearly hobble new entrants. It is understood that, on several occasions when negotiations had reached an impasse, an Ansett negotiator would leave the room for a few minutes. Soon after, the government negotiator would be called out for a telephone call "from the Prime Minister's office." Given the history of the Prime Minister Hawke's indebtedness to the Chairman of Ansett, Sir Peter Abeles, there is speculation that Sir Peter engineered a major strategic victory on this occasion. (As reported to the authors by Bryan Grey, in his office, July 17, 1991.)

6 *The Failure of Compass Airlines*, Report by the Trade Practices Commission, February 1992, p.35.

7 TPC Report, February 1992, p.36.

8 TPC Report, February 1992, p.55.

9 Budget went into liquidation in early 1992, although several hundred franchisees continue to operate their businesses under that name.

10 Source: Bryan Grey, quoted in *The Australian*, October 4, 1991.

11 BTCE Report 73, November 1991.

12 By October 1991, after the delivery of its fifth Airbus, Compass had augmented the capacity of the Airline industry by 40%.

13 Compass was unable to gain satisfactory terminal facilties from either Ansett or Australian, and at the eleventh hour the FAC repainted and converted a hanger into terminal facilities for them.

14 See BTCE Report 73, pp. 63-65.

15 "Compass Soars to 21pc Share," Richard Blackburn, *The Australian*, July 18, 1991.

16 "Australian Earns $66m after extras," Richard Blackburn, *The Australian*, October 4, 1991.

17 In mid-September the price war spread to the regional airlines. Eastern Australia Airlines, a wholly-owned subsidiary of Australian, and the independent regional carrier Hazelton Airlines, each began offering 70% discounts to and from rural airports. Australian no doubt wished to increase feeder traffic, and perhaps also to consolidate its regional position.

18 See BTCE Report 73, *Deregulation of Domestic Aviation: The First Year*, pp. 35-37.

19 *Monitoring of Movements in Average Airfares, Report No.1* Prices Surveillance Authority, Feb. 1992.

20 See Roy Morgan Air Travel Index, July 1991

21 "Australian leads in flush Business Class," Richard Blackburn, *The Australian*, October 17, 1991.

22 See BTCE Report 73, p.28.

23 See BTCE Report 73, p.34.

24 See *Business Review Weekly*, November 29, 1991, pp. 44-45.

25 "Compass plan to cut back routes," Richard Blackburn, *The Australian*, December 9, 1991. According to the Trade Practices Commission Report of February 1992, Compass declined to pursue charges of predatory pricing when it was invited to do so on at least two separate occasions (perhaps earlier than this date) in 1991.

26 Gregor MacAuley, Compass Vice-President for Marketing, told a gathering at Bond University on December 9, 1991, that Compass needed $1m per day to breakeven. The TPC Report indicates that Compass' average revenue per passenger was only about $100 at this time, thereby yielding only $800,000 per day even in this peak period.

27 Some attributes of quality are not discernible *a priori*, such as the actual quality of inflight meals and service, and the actual time of arrival, and the safety issues, but most consumers probably expect these to conform to previous patterns which they are able to observe or about which they are able to gain information.

28 The price elasticity of demand for business travel will be considerably less elastic than for leisure travel, of course. The firm may wish to follow a differentiation strategy in the business travel market while pursuing a cost-leadership strategy in the leisure travel market,

29 The profit-maximising markup is equal to $-1/(e+1)$, where e is the price elasticity of demand. See, E.J. Douglas, *Managerial Economics: Analaysis and Strategy*, (Prentice-Hall, Inc, 4th ed. 1992, pp. 424-27.)

30 See Dorfman and Steiner [1954] or Douglas [1992] pp. 566.

31 In 1987, Delta Airlines spent $88m, or 1.38% of sales, on advertising. Anheuser-Busch, the brewer, spent $604m, or 7.31% of sales, and Coca-Cola spent $1,075m, or 32.31% of sales.

32 It is estimated that 85% of Australians had never flown, or had not flown in the ten years prior to deregulation. Compass surveys indicate that 30-40% of passengers on Compass (particularly on the Cairns and Perth routes) were first timers.

33 X-inefficiency is due to 'managerial slack' and refers to the extent to which management allows unit costs to be higher than they would be if subjected to the pressures of intense competition. See Leibenstein [1966] and Williamson [1963].

34 Keeping in mind that Compass started with $65m in capital from its public float, $24m of this was tied up in security deposits on the leased aircraft, and the lease costs were about 30% of its direct operating costs. See TPC Report p.14.

35 Indeed, the fourth of the five Compass aircraft was an Airbus A310, a smaller (210 seats) and presumably less expensive aircraft.

36 East-West's BAe 146 aircraft are fitted with five-across rather than six-across seating, and offer the widest economy class seats in Australia. But since these aircraft are narrow bodied and not as roomy as the Airbus, it is probably fair to say that the quality of Compass economy class also exceeded that of East-West's.

37 TPC Report, February 1992, p.17.

38 PSA Report, Feb. 1992.

39 See BTCE Report 73, Chapter 6.

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