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DISCUSSION PAPERS

"Airline Competition and Strategy in Australia"

by

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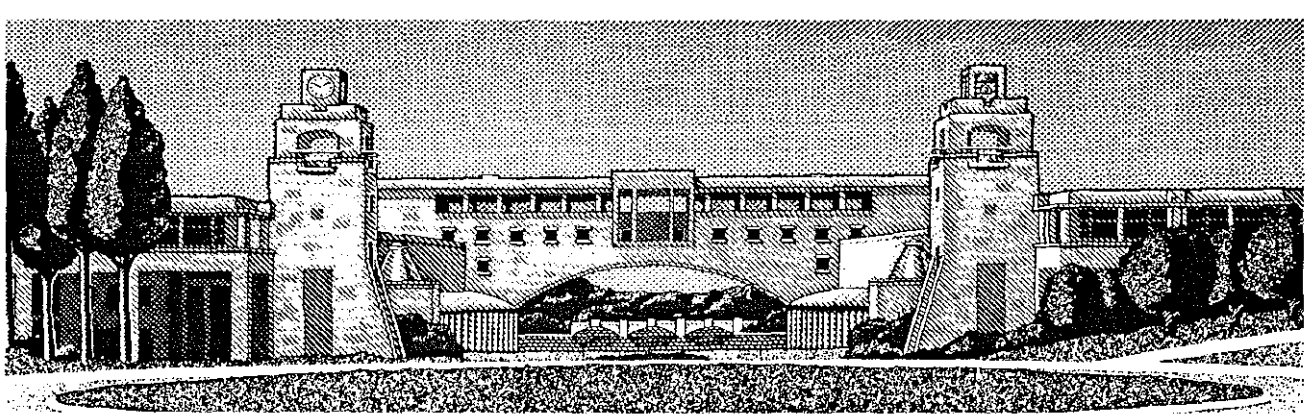

B O N D U N I V E R S I T Y

AIRLINE COMPETITION AND STRATEGY IN AUSTRALIA

by

Evan J. Douglas
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AIRLINE COMPETITION AND STRATEGY IN AUSTRALIA

I. OVERVIEW

In November 1990 Australia's domestic airline markets were deregulated. One month later a sole new entrant, Compass Airlines, began carrying passengers in competition with the two incumbent major airlines (Ansett and Australian). There ensued a series of price wars which ended abruptly when Compass was grounded by its creditors on December 20, 1991. Recriminations then flew, with Compass management (and much of public opinion) blaming the Government and the entrenched airlines for lack of a 'level playing field.' The Government (and the entrenched airlines) blamed Compass mis-management for the lost stockholders funds, the unrecoverable prepaid airfares, and the vast losses of all three airlines. The public was outraged at the loss of heavily discounted airfares.

In August 1992, Southern Cross Airlines, who had waited in the wings while Compass tested the waters, purchased the remnants of Compass and began carrying passengers under the revived Compass (mark II) logo. Despite apparent public support, their public float was only 54% subscribed, (thus involving the underwriters, including the Queensland Government, as stockholders). It seemed that the new management had learned from the mistakes of Compass (mark I). Initially pricing was orderly, but within months Compass was forced to match discounts of the incumbents, and by March 11, 1993, Compass had ceased flying and a new round of lawsuits had begun.

In this paper the short history of airline deregulation in Australian is considered. The pre-deregulation moves by the incumbents to strengthen their position are outlined, and the year of price competition occasioned by the entry of Compass (mark I) is discussed in some detail, with a brief account of the six months life of Compass (mark II). The failure of Compass to successfully enter the market is considered in terms of the actions and inactions of the Government, the alleged strategic errors made by Compass management, and the 'hardball' competition of the incumbent airlines. I then conclude that it was inevitable that Compass would die of 'natural' causes.

II. SIGNIFICANT EVENTS ON THE EVE OF DEREGULATION

Following a decade of debate, deregulation was announced on October 31, 1987 to begin three years later, such notice being required by law. Well prior to this, deregulation was foreseen by the incumbent airlines and they took significant steps to strengthen their competitive position.

Mergers and Takeover Activity

Ansett Airlines acquired East-West Airlines in July 1987, as the first strategic response to imminent deregulation.[1] Australian Airlines then acquired Eastern Australian, Sunstate Mildura and Sunstate Queensland airlines. Each one of these mergers was given the green light by the Trade Practices Commission. Continuing into 1991, Ansett established Ansett Express as a regional airline and Australian similarly launched Australian Airlink.

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 significant new regional carriers.

The Gates Agreement

The 'gates agreement' provides that Ansett and Australian 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 agreement, between the Government and the two major airlines, was finalised on the evening of December 31, 1987, the day before the Federal Airports Corporation (FAC) began operation. The FAC was established well prior this date to take over from the Government, effective January 1, 1988, the ownership of and responsibility for the efficient operation of

Australia's major airports. Thus, the incoming Director of the FAC was handed a *fait accompli* that almost totally curtailed his ability to provide new entrants with adequate terminal facilities.[2]

This restriction on gate availability ensured that any new entrant would have great difficulty 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.[3] 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.[4] 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.

The gates agreement forced Compass to abandon initial plans to use smaller aircraft with more-frequent scheduling to more airports. Planning shifted to the larger Boeing 767, which were to be serviced by Qantas. 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, and the aircraft choice became the larger Airbus A300-600R. Consequently, Compass were forced to reduce flight frequency and the number of airports that could be served. Moreover, the higher breakeven volume on the larger planes meant that Compass would need even deeper discounts to expand the market sufficiently to reach breakeven load factors.

The Pilots' Strike

The third significant setback for Compass Airlines followed the abortive Pilots' Strike of 1989. Anticipating that deregulation would be accompanied by salary rollbacks and pilot layoffs, as in the US situation, the pilots union called a nationwide strike that lasted five months. Immediately, the Government provided Air Force troop transports to move stranded passengers, and permitted international airlines to carry passengers between Australian cities.

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 two 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 abrupt resignation *en masse* was a cost-saving boon for the incumbent airlines. Only about half of the 1,647 striking pilots were ultimately re-employed, allowing the airlines to restructure their operating budgets, both in terms of average pilot salaries, pilot workloads, and the number of pilots on their payrolls.

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. Unable to gain access to this system on agreeable terms, Compass signed on with the 'Fantasia' system being promoted by Qantas and used by 1,308 travel agents.[5] 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. In 1992, (too late for Compass mark I), the Trade Practices Commission cleared the merger of the 'Fantasia' system with the Galileo system for a single Australia-wide CRS.[6]

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 a major 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. 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, which subsequently failed, and with other firms in the travel and hospitality industries.[7]

III THE DEREGULATION EXPERIENCE

Airline deregulation in Australia occurred during a severe recession, which would have caused passenger volume to fall, it is estimated, by 20-30% during 1991, other things being equal. But 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.[8] Revenue-Passenger-Kilometres flown in the year ended September 1991 were 45% greater (at 16.1 billion) than RPKs in the preceding year.[9]

In October 1990, the incumbent firms leapt into action, provoked by the opening of bookings for Compass flights. They offered mild discounts on some routes, and simultaneously launched a non-price battle for the business flyer, upgrading their cabins and stressing the features of their members-only clubs at major airports.

Compass began flying on December 1, 1990, and faced many problems in the first months. Aircraft deliveries were delayed, requiring flight cancellations and rescheduling. Aircraft were delivered with '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 was inevitably negative. Bookings were 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.

Compass had announced that its fares would be 20% below the standard economy (and 50% below the curfew) fares of the incumbents. As an example, the Sydney-Melbourne one-way fare on either incumbent airline was $229, and the Compass fare would be $184. But the addition of three Airbus 300–600R aircraft to the domestic market by Compass served to increase airline capacity significantly, and a price war was inevitable.[10]

The Price Wars

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, but the conditions attached to the Compass fares were much less restrictive. Conditions on the Ansett and Australian fares were later relaxed somewhat, and there followed a three month ceasefire.

On May 3, Compass introduced its 70% discount "Recession Buster" fares 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 Sydney-Melbourne fares fell from $100 to $85.

This skirmish continued into July, with Ansett extending its 55-70% discounts to 156 routes (including non-Compass routes.) Australian cut $10 off fares into Adelaide a week before Compass began serving Adelaide on July 15, 1991. Ansett matched these fares, and Compass 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 Australian tourist dollar. Similarly, rail and bus companies were cancelling services and reducing fares as they felt the brunt of intermodal substitution.[11]

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.[12]

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.[13] 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, 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 booklets of tickets at deep discounts in an effort to capture more of the business travel market.[14]

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%.[15]

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.[16]

On December 18, 1991, Polaris Holdings attempted to re-possess a Compass aircraft for non-payment of fees. The same day, press reports claimed Compass officials were seeking from the Minister of Aviation an $18m sale of tickets for Government employees, to avoid loss of the aircraft. The next day, the Civil Aviation Authority (CAA) placed statutory liens on the Compass 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 incumbent airlines and by Qantas.[17]

Public outcry forced political interest, and vigorous debate followed in Parliament and in the media. Compass employees marched through city streets, raising $5 million in public donations. Bryan Grey searched for a corporate white knight, blaming the Government for the demise. The Minister for Aviation was most vocal on the part of the Government, placing the blame squarely on Compass management. The Trade Practices Commision, having declined to launch formal investigations previously, was charged with investigating circumstances behind the failure of Compass, and later reported no evidence of predatory pricing or misuse of market power (to the amazement of many observers). The Government's response was to announce plans for new terminal construction at several airports, and for the amalgamation of Qantas and Australian Airlines, and to later privatise that new entity.

In August, 1992, Southern Cross Airlines (who had been waiting in the wings since 1990) floated stock with the aid of underwriters and purchased the remaining Compass assets. Employing about 60% of Compass staff, they began flying smaller (McDonnell Douglas MD80) aircraft under the Compass logo on August 31, 1992. The new management, this time with US experience, avoided most of the strategic management mistakes made by Compass (mark I), but nonetheless failed to maintain viability while chipping away at the walls erected and maintained by the Government and the incumbent airlines, and Compass finally collapsed on March 4, 1993.

IV. THE FAILURE OF COMPASS AIRLINES

The failure of Compass has been attributed to a variety of major causes. I shall discuss each of the popular reasons cited for their demise and then argue that it was inevitable regardless of the presence or absence of these factors. That is, a third airline was doomed from the start.

Government Assistance

The Federal Government was not an impartial bystander: it owns Australian Airlines, and the (then) Prime Minister had a strong personal and political relationship with the (then) head of Ansett Airlines. The Government was forced into deregulation by wider political pressure but did not throw its weight behind it. The Government allowed the incumbents to control all the airport 'gates' except one or two in each airport, thus restricting the flight frequency that could be offered by any entrant. This agreement, made at the eleventh hour prior to handing over responsibility to the Federal Airports Corporation, defies explanation in terms of the wider public benefit.

The Government moved decisively to help the incumbent airlines break the Pilots' strike, which allowed them to reduce their staffing costs dramatically just prior to the beginning of deregulation. The Government directed Qantas not to service Compass aircraft (a plan which appeared to have business advantages for both parties). Government employees were not encouraged to utilise the new airline, and government agencies like the Trade Practices Commission (TPC) and the Prices Surveillance Authority (PSA) did not seem willing to protect Compass. Nor did the Government make any moves to help Compass stay afloat.

Despite all this Governmental assistance, it was argued, by the (then) Minister for Aviation, and by the incumbent airlines, among others, that Compass (mark I) failed because of series strategic errors made by Compass management. Compass (mark II) largely avoided those strategic errors, but ultimately suffered the same fate. It is worthwhile examining the factors that are popularly considered to be the contributing causes of failure for Compass before moving on to discuss the root cause.

Lack of a Defined Competitive Strategy

Compass (mark I) seemed to be launching a cost-leader airline, planning to operate a one-class service at fares 20–50% below the listed economy fares of the incumbent airlines. The founding Chairman, Bryan Grey, emphasised that only Compass could afford the lower fares because of the lower operating costs associated with a single type of aircraft, the fuel efficiency of the Airbus, and leaner corporate structure. Trying to avoid direct confrontation, he stressed that Compass 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 while Compass appeared to be following a cost-leadership strategy, several subsequent decisions were not in accord with that strategy, and the strategic positioning of Compass was probably never clearly articulated, and indeed continued to shift with the wind. Necessity soon drive Compass in pursuit of the higher-margin business traffic, which left them with a one-class cabin that was 'too good' for the vacation/leisure markets yet they lacked the flight frequency, airport lounges, and frequent flyer programs necessary to attract the business flyer. The following management decisions deserve more comment.

Choice of Aircraft and Fitout

There were four main problems with the aircraft, when seen in the context of a cost-leadership strategy. First, they were too expensive to lease and too expensive to fly if projected load factors did not materialise.[18] There were hundreds of planes idle worldwide, and it seems unlikely that all other companies servicing aircraft in Australia would have been unwilling to service Boeing or McDonnell-Douglas aircraft. Less than two years later, Southern Cross announced they would save over $40 million per annum by using MD80 aircraft, relative to the original Compass aircraft leasing and service costs.

Second, the aircraft were of higher quality than necessary for a cost-leadership strategy. Wide-bodied aircraft attract a premium, as do more youthful aircraft. Given 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 lesson learned by Southern Cross.

Third, the 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) was an expensive mistake. Seat pitch (legroom) was increased to 86cm, the same as Business class in the incumbent airlines. Compass also introduced inflight video to Australian travellers, and claimed the best economy class in Australia.[19] 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 much higher than its rivals appears was surely a costly diversion from its strategy of cost-leadership.

Finally, the aircraft were too large. Bryan Grey stated many times that the limited availability of terminal facilities forced him to choose larger aircraft. But larger planes also take longer to turn around, as loading and unloading times increase commensurately. Utilising smaller aircraft, as Southern Cross later did, sacrifices some economies of aircraft size, but allows better flight frequency, widely regarded as the key to success in the airline business.

Forecasting Errors

Given the gates constraint, and the choice of aircraft, Compass apparently chose its seat configuration on the basis of its estimates of demand. They apparently 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 planning did not include sensitivity analysis to alert them to the impact on demand of a severe recession.

Compass also 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 indicate Bryan Grey did not expect 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 the

incumbents would not 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 (mark I) confused the long run impossibility of rivals' pricing below full cost with the short run strategy of their pricing below full cost in the expectation of outlasting the new entrant's limited finances. Compass (mark II) announced they would not be lured into price wars, and managed to hold to this until the January lull (1993) when they were forced to match widespread discounting to maintain load factors.[20]

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 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 elsewhere, and would have been a natural outcome in Australia.

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 to match those of the incumbent airlines, Compass would have had to offer a compensating price differential (that is, cheaper business class fares) but the additional in-flight and terminal 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. In recognition of this error, Compass had been seating business travellers ("suits") in the front of the aircraft since about mid-year and announced in December 1990 that they would soon offer 'Corporate Class' service.

Compass (mark II) set up a business class cabin, with a corporate travel (frequent flyer) plan based on corporate dollars spent. Since their airport lounges were less lavish than the incumbents and their flight frequency was inferior, their business fares were necessarily lower. Still, they were unable to penetrate significantly the travel budgets of larger companies who were held captive by travel agent commission overrides, international frequent flyer plans, and other benefits supplied by the incumbent airlines and their related travel agencies.

Insufficient Yield Management

Compass (mark I) consistently offered discounted fares without 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 (mark I) management to implement a better yield management system was a serious error. A better yield management system was to be acquired in 1992.[21]

Compass (mark II) implemented a better system, but in reponse to an apparent public preference for a few simple fare categories, adopted a simple fare system with only six basic fares on each route – these being peak and off-peak fares for business and economy class, and 7-day and 14-day APEX fares. Compass stuck to these four months, ignoring discounts offered by the incumbents until forced to match them in January 1993 to maintain load factors in the low-traffic period between Christmas and Easter. By March, their cash reserves were dangerously low, and they were desperately seeking additional loan funding at the time of their demise.

Insufficient Initial Capitalisation

The most popular verdict for the failure of Compass (in each of its lives) was that they were undercapitalised. They needed, it is said, a larger initial cash balance to tide them over the early losses they must inevitably make until they became accepted by the flying public as a viable third airline. But this is too simplistic: at the rate Compass (mark I) was losing money, another $50m of initial capitalisation would have kept them solvent for only a few more months. Compass (mark II) built planned for sufficent initial cash reserves to withstand two years of losses, but these were depleted by higher than expected deposits required for the aircraft leases, and lower than expected penetration of the business class market.

I shall argue later that insufficient capital was indeed the root cause of the demise of Compass, but that their problem was somewhat more complicated than surviving an initial lean period. Rather, Compass had to survive long enough to see one of the major incumbent airlines go bankrupt and disappear perish before they could be assured of survival.

Unfair Competition from the Incumbent Airlines

Many cried foul when Ansett and Australian moved to protect their market shares with aggressive pricing and other marketing strategies. Compass only contested a subset of the city-pair markets, and it is evident that prices did not fall by very much into some non-Compass cities (such as Canberra and Hobart).[22] Thus the possibility of predatory pricing was raised, particularly on flights to/from Perth, but the Trade Practices Commission declined to launch an investigation until directed to after the demise of Compass (mark I).

As a corrollary tactic, the incumbents flooded some markets with excess capacity just as Compass was about to enter those markets, as in the case of Adelaide (mark I) and Coolangatta (mark II). This prevented all airlines from attaining breakeven load factors, but the incumbents were better able to support this with higher load factors on other routes, and the ability to make larger losses before becoming technically insolvent.

The incumbents emphasised their differentiation in terms of their extensive route networks, their greater flight frequencies, the comfort of their business class cabins and airport clubs, their frequent flyer programs, and so on. They utilised the travel agent commission overrides (TACOs) and corporate accounts/discounts to great effect to minimise switching of the business flyer. It should be noted that after the demise of Compass (mark I), 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".[23]

V. THE DOMESTIC MARKET IS A NATURAL DUOPOLY!

Finally we come to the root cause of the demise of the third airline. I believe it has been amply demonstrated that the domestic market is too small, relative to the cost structures of modern airline companies, to support three major airlines operating jet aircraft.

This can be modeled in terms of Figure I. The 'Two Airlines' policy meant that market demand was initially shared equally between the two incumbent airlines. The entry of Compass, and the 10% market share ultimately acquired by Compass (mark I) is reflected by the shift of the incumbent firms' demand curves from D to D' and the emergence of the entrant

firms demand curve D". These are *mutatis mutandis* demand curves because the three firms typically raised or lowered their prices jointly. As such, they also depict a constant market share. The cost structures of the incumbent airlines are not shown, but we can assume that their long run average cost (LAC) curves lie above the LAC of the entrant airline, which is shown in the figure.

The pre-entry price for a typical market is shown as P_1. The post-entry price for that market is shown as P_2. Note that as the price is reduced from P_1 to P_2, market demand expands, the sales volume going to each of the incumbent firms increases from Q to Q', and the sales volume going to the entrant expands to Q". Most importantly, the relationship of the entrant firm's demand curve to its cost curves mean that at every sales volume level, per unit cost exceeds price.

That is to say, as long as the incumbent firms match the price reductions of an entrant firm, the latter's attempt to expand the market by price reductions will simply increase its losses, as there is no output level (except perhaps at the initial price P_1) where price exceeds unit costs. Note that the incumbent firms will also incur losses, indeed they will incur greater losses, as they are assumed to have a cost disadvantage, at least initially.

Thus, it comes down to a bleeding competition: the two firms that can bleed longest without dying, win. The incumbents were losing money at a rate far higher than the entrant, but they had 'deeper pockets'. One is a Government-owned taxpayer-funded airline, and the other is a major component of a transportation and media conglomerate.[24] Thus the popular opinion that Compass was underfunded, while basically correct, is too simplistic. An entrant would need massive funding to outlast at least one of the incumbent airlines in a price war before it could be assured of survival, because there is simply not room for three airlines.

VI. SUMMARY AND CONCLUSIONS

The experience of Australia's brief history of airline deregulation was recounted and an autopsy was performed on the entrant firms. It was noted that the entrants received little support from the Government, and faced determined opposition from the incumbent airlines. It was also noted that several strategic management mistakes were committed by Compass (mark I) and that

these were largely avoided by Compass (mark II), yet the latter still could not survive in the domestic market. Finally, the conclusion was reached that the entry of a third airline was doomed in any event because the domestic Australian airline markets are natural duopolies (with the less dense routes being natural monopolies) and that this allows the high-cost incumbents to prevent successful entry of a relatively low-cost new entrant.

In 1993 and beyond, with the era of global airlines fast upon us, the market may not even be large enough for two domestic airlines if more efficient global airlines are permitted to compete on domestic routes. The economics of airlines now means that domestic airlines must forge strategic alliances with international airlines to obtain the demand-side efficiencies (primarily the route networks, travel agent networks, and the frequent flyer linkages) sought by the flying public, and the cost-side efficiencies (primarily the economies of scope) needed to maintain profitable operation.

It now seems obvious that there will be no more new startup airlines entering the domestic market, apart from new regional or feeder services operating a few small non-jet aircraft. From now on the only new airlines that will enter to fly scheduled jet service on domestic routes will be international airlines given fifth freedom rights by the Australian government. Once Qantas, the national carrier, is fully privatised as planned for later this year, the issuance of such rights by the Government may be expected if and when it is politically expedient to do so. Already, Air New Zealand has been given these rights, but have not yet begun service due to a conflict over the fifth freedom rights of Ansett in New Zealand cities.

Qantas took over Australian Airlines in late 1992, and by May 1993 the Australian logo began to disappear as 'Qantas Australian Airlines' became a full service domestic and international airline. 25% of the equity in Qantas is now owned by British Airways, which also has a stake in USAir and is moving to become a major global airline. Similarly, Ansett may now carry passengers internationally, and has been awarded routes into neighbouring countries. It has formed a formidable alliance for a global network of destinations and frequent flyer points with several major international airlines including United, Singapore, and Japan Air Lines. We have entered an era in which nations will negotiate with each other for fifth freedom rights in each other's airports just as fervently as they negotiate tarriff and trade deals. It would

seem that the era of domestic airline deregulation is over, and that the era of global airline regulation has begun.

It was not my purpose here to discuss whether or not deregulation was a 'success' in the Australian context. Across a variety of measures of quality, the data indicates that, following deregulation, service quality has either risen or remained at an acceptably high level.[25] Average airfares are now some 18% lower in real terms than they were pre-deregulation. They fell from an index of 100 to around 70 while Compass (mark I) was operating, then rose back to 90 after the demise of Compass (mark I), and fell again (to about 80) after Compass re-entered the market.[26] Almost certainly more recent figures will show that without a third airline, airfares have risen again. Given the improbability of another new airline entering, hopes for continued downward pressure on airfares rest with opening the domestic market to international carriers.

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FOOTNOTES

[1] *Deregulation of Domestic Aviation: The First Year*, Report 73, Bureau of Transport and Communications Economics, Australian Government Printer, Canberra, November 1991.

[2] Why would the Government 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." There is speculation that the (then) Chairman of Ansett, Sir Peter Abeles, engineered a major strategic victory on this occasion.

[3] 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.

[4] 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.

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

[6] *ibid*, TPC Report, February 1992, p.36.

[7] Budget went into liquidation in early 1992, although several hundred franchisees continue to operate under that name.

[8] Source: Bryan Grey, quoted in *The Australian*, October 4, 1991.

[9] *ibid*, BTCE Report 73, November 1991.

[10] By October 1991, after the delivery of its fifth Airbus, Compass had augmented total airline capacity by 40%.

[11] See BTCE Report 73, pp. 63-65.

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

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

[14] 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, 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.

[15] See BTCE Report 73, p.28.

[16] See BTCE Report 73, p.34.

[17] 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.

[18] 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.

[19] Although East-West offered the widest economy class seats, their aircraft are narrow bodied and not as roomy as the Airbus, so it is probably fair to say that the quality of Compass economy class also exceeded that of East-West's.

[20] *The Australian*, January 7, 1993.

[21] See TPC Report, February 1992, p.17.

[22] *ibid*, BTCE Report 73, November 1991.

[23] *ibid*, TPC Report, February 1992, p.55.

[24] An indicator of the synergy between the transportation and media components was the January 1993 advertising campaign by Ansett and Eastwest conducted extensively in News Limited newspapers.

[25] *Quality of Service in Australian Passenger Aviation*, Report 80, Bureau of Transport and Communication Economics, Australian Government Printing Service, Canberra, 1992.

[26] *Monitoring of Movements in Average Air Fares*, Report No. 3, Prices Surveillance Authority, December 1992.

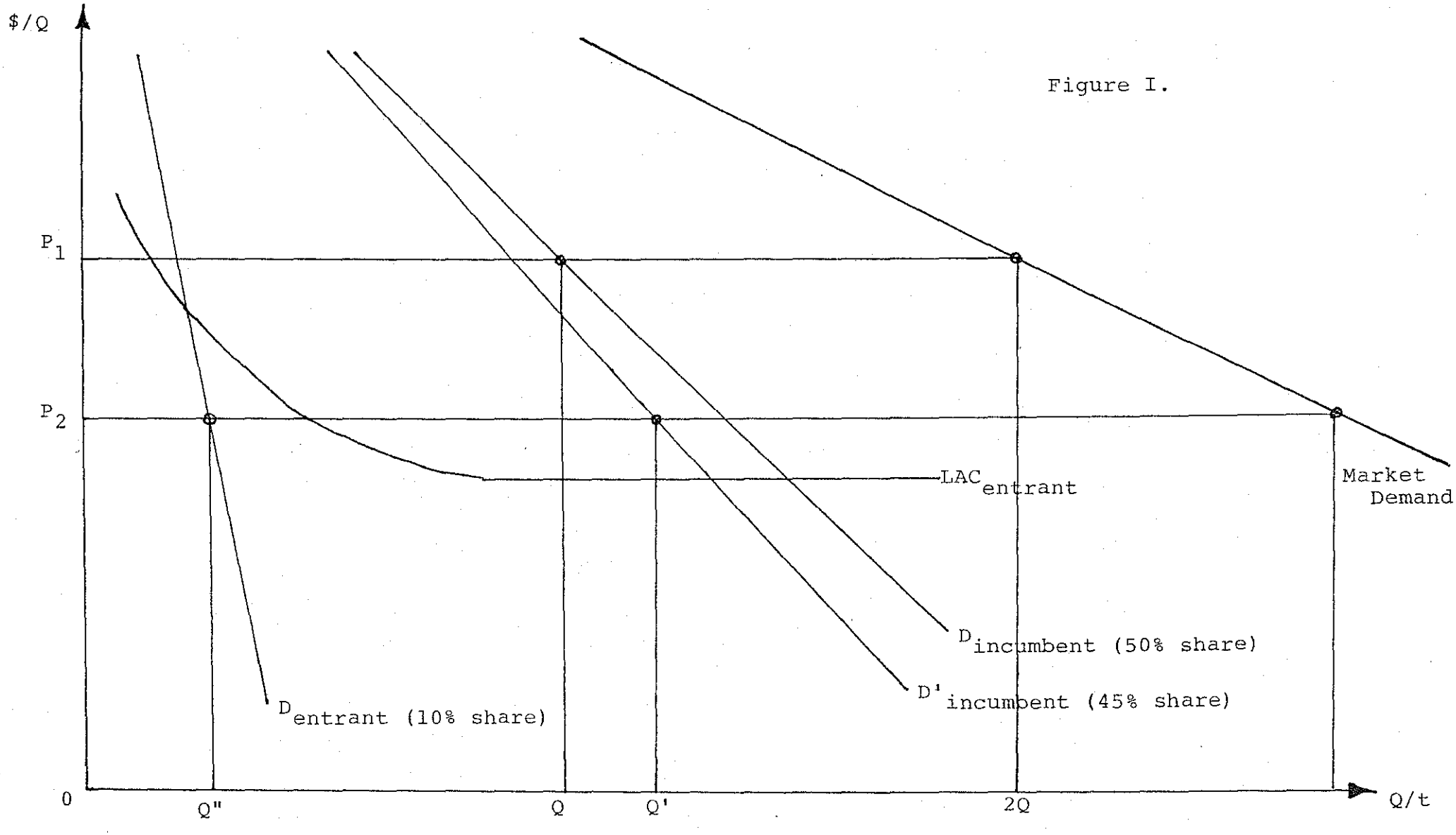
$/Q
P1
P2
LAC entrant
Market Demand
D incumbent (50% share)
D' incumbent (45% share)
D entrant (10% share)
0
Q"
Q
Q'
2Q
Q/t

Figure I.