WORLDWIDE AIR TRANSPORT CONFERENCE: CHALLENGES AND OPPORTUNITIES OF LIBERALIZATION

Montreal, 24 to 29 March 2003

Agenda Item 1: Preview
1.1: Background to and experience of liberalization

COMMERCIALIZATION AND LIBERALIZATION

(Presented by the Secretariat)

SUMMARY

This paper reviews developments in and implications arising from the commercialization of airlines, airports and air navigation service providers in the broader context of the liberalization experience.

Action by the Conference is in paragraph 4.1.

REFERENCES

Circular 291, *The World of Civil Aviation 2001-2004*
Circular 284, *Privatization in the Provision of Airports and Air Navigation Services*

1. INTRODUCTION

1.1 Economic liberalization and globalization since the last Worldwide Air Transport Conference (AT Conf/4) in 1994 has brought about fundamental changes in the commercial environment of air transport. This paper provides a brief overview of commercialization developments in the airline industry, including changes in corporate structures and business models and the commercialization of airports and air navigation service providers. The paper focuses in particular on some of the consequences and implications of commercialization.

1.2 The privatization and commercialization of airlines, airports and air navigation service providers are part of the broader trends associated with globalization and liberalization across all economic sectors as governments reduce or withdraw from the ownership and management of many State entities. Major regulatory and industry trends and developments related to market access are covered separately by

ATConf/5-WP/21. More detailed information on trends and developments as regards airlines, airports and air navigation service providers, covering the year 2001, can be found in the Chapters 2 and 3 of *The World of Civil Aviation 2001-2004* (Circular 291).

2. RECENT DEVELOPMENTS

2.1 **Airline corporate structure.** Privatization with respect to airlines is a term that is often loosely applied. It tends to be more of a process than a quantifiable objective or result. The process is one of divestment, by various methods, of government-owned or -controlled equity and may be carried out in a phased manner over time. Some governments may consider a minor sale of shares as "privatization". Subject to this use of the term, the privatization of State-owned airlines has been one of the preeminent transformations in international air transport, where airlines in all but a handful of States had been government owned until recent times. The motives for privatization have been highly diverse, ranging from purely economic considerations, to improving operating efficiency and competitiveness, to a more pragmatic desire to reduce the heavy financial burden for governments for financing capital investment in new equipment. Whatever the reasons, the privatization of airlines has accompanied a more commercially-oriented outlook within an increasingly competitive environment. Since 1985, about 130 governments announced privatization plans or expressed their intentions of privatization for approximately 180 State-owned airlines. During this period, 86 of these targeted carriers have achieved their privatization goals.

2.2 It should be noted, however, that achievement of privatization has not been easy. Many of the initial privatization plans had to be deferred or postponed because of the complexities encountered in the process or the economic condition of the airlines concerned, or local circumstances. But in most such cases the intention to privatize remains. The uncertainties surrounding the privatization process are also illustrated by a small counter trend of renewal, usually as a temporary measure, of government ownership as a national interest response to the potential demise of a national airline.

2.3 Airline business models

In the commercialization of the airline business, considerable attention is being devoted to the most appropriate airline business models for viability in particular market circumstances. The following is a review of some current developments in this regard.

2.3.1 **Full service network business model**. As market access has been liberalized domestically and internationally, airline strategy and planning has shifted from traditional point-to-point route development to one based on network markets. Not only full service major airlines but also many national airlines in developing countries have realigned their route structures and increased the size and reach of their network especially by forming "hub-and-spoke" networks, through which they can take advantage of economies of scale and scope. Hub-and-spoke networks enable an airline to operate more frequent services (which are attractive to high-yield business passengers) than could be achieved by point-to-point networks, and also to serve small cities that have insufficient traffic to support regular non-stop services. In order to develop "hub-and-spoke" networks, airlines do not necessarily operate all services on all routes themselves, but mostly through close cooperation with other airlines in codesharing, block spacing and franchising agreements at little additional costs (see ATConf/5-WP/21). At the same time the "hub-and-spoke" network trend is not applied exclusively. Once demand rises to a viable level, point-to-point services are frequently introduced (initially with relatively small aircraft) and a continually tailored balance maintained with "hub-and-spoke" operations.

2.3.2 Airlines with large networks have a number of competitive advantages stemming from certain scale and scope economies over smaller or even low-cost airlines. These advantages, which also offset their relatively higher cost structures to a large extent, are ones of network size and attractiveness to customers, marketing and selling and distribution power, and customer loyalty schemes. They have also developed complex tariff structures and use sophisticated yield management systems to maximize revenue from individual flights. The viability of the full network business model is dependent primarily on high-yield business passengers by its very nature and is still valid to generate profits in many circumstances, but competition and the downward pressure on discounted fares, and consequently on yields, puts this business model under increasing scrutiny and reassessment.

2.3.3 **Low-cost business model.** In recent years, successful low-cost carriers have been challenging the full service network models of major airlines. The common features of the business model of low-cost carriers are, with some variations: point-to-point network focussing on short-haul routes, high frequencies, simple low-fare structures, high-density single class with no seat assignment, simple in-flight services, staffing flexibility and minimal overheads, and intensive use of electronic commerce for marketing and distribution (including on-line booking via the internet and electronic ticketing). To sustain low-cost structures, these carriers usually operate a single aircraft type with higher daily aircraft utilization. They also use less-congested secondary airports to ensure short turnrounds and high punctuality and to save airport related costs. It is the low operating costs that enable low-cost carriers to allocate all their seats to low fares. This low-cost formula is not new but has been adopted by many new entrants in the United States following domestic deregulation. Although only few of the earlier new entrants survived, successful low-cost carriers have established sustainable significant cost advantages, and grown rapidly not only at national level (for example, Southwest Airlines and jetBlue Airways in the United States, Virgin Blue Airlines in Australia) but increasingly regionally (for example, Ryanair and easyJet in Europe), and some of them have offered sufficient incentive to become attractive to business passengers. Other entrants into the low-cost market, primarily in the Europe-Mediterranean area, are former tour operator and charter carriers, who are increasing their "seat only" offerings to reflect the increasing flexibility demanded by their customers and to avoid loss of business to the new low-cost carriers. The low-cost formula is likely to spread to other regions and increasingly to international services where market conditions allow and regulatory arrangements permit.

2.3.4 Major airlines have generally reacted to competition from low-cost new entrants in the first instance by cutting restrictions on low fares with limited availability. Because of perceived scale and scope advantages of major airlines, this selective-matching strategy has been workable in many cases, but could not always protect market shares in competing head-on with several low-cost airlines enjoying sustainable significant cost advantages. Also, major airlines have suffered from falling yields in the prolonged economic slowdown, bringing less business travel demand and business passengers buying-down to lower, restrictive fares. Furthermore, many business passengers have switched from major airlines, which have been increasing high end of unrestricted fares to compensate for falling yields and rising jet fuel prices, to low-cost carriers.

2.3.5 **Alternative business models.** Facing growing cost pressures and inability to continue to charge business passengers higher fares, business priorities of major airlines have been forced to shift to redesigning their operation to run more efficiently and developing alternative models which serve to bring passengers (especially business passengers) back to them. One of the responses taken by major airlines is to set up separate organizations or subsidiaries to handle operations on short-haul routes competing with low-cost carriers or having potential threats of new entrants. This low-cost "airline-within-an-airline" strategy taken by major airlines tries to combine key ingredients of low-cost carriers' approach with the reputation and quality of their own brand (for example, Delta Air Lines' Song and Tango by Air Canada), though initially only with limited success (for example, British Airways' Go and KLM's Buzz were sold to competitors, while Continental Lite, Shuttle by United and US Airways' MetroJet were shut down). Again, this "airline-within-an-airline" is a formula that is likely to take on an international dimension including long-haul and leisure-oriented routes, as it already has in the case of Australian Airlines, a low-cost subsidiary of Qantas, intended to serve certain Asian markets.

2.4 **Commercialization of airports and air navigation service providers**. While on the air carrier side, the industry has been transformed into a competitive commercially oriented one, for airports and air navigation service providers the change has been a slower but nonetheless significant move towards financial and organizational autonomy and commercialization. In the case of airports there has been a steady trend towards private participation and privatization. On the air navigation services side the trend has been towards commercialization rather than privatization. These developments, as well as their regulatory implications (given that airports and air navigation service providers are in essence monopolistic services) are reviewed in a recent ICAO study "Privatization in the Provision of Airports and Air Navigation Service Providers" (Circular 284). The study also provides guidance on the privatization and commercialization process.

2.5 In parallel with the increasing participation of private interests in the management, operation and financing of airports, airport business opportunities have dramatically increased. The increasingly commercial outlook for airports manifests itself in a number of ways, such as in: increased emphasis on generation of non-aeronautical revenues; airports having to market their services and attract airline business; the "airport city" concept of growth and development; the importance of international hub airports; the relationship between hubs and major airline alliances; and airport specialization, for example where airports are in close proximity to one another. Each of these has a competitive element, notwithstanding the local monopoly characteristic of airports.

2.6 A more liberalized environment for airlines has some countervailing implications for airports. On the one hand it increases the opportunities for airlines to serve more airports, which may have a positive effect on airport sustainability. However, greater operational flexibility for airlines may also result in a reluctance to serve remote airports or airports with limited market potential, with an adverse effect on the revenue prospects for such airports. Furthermore, the liberalized environment for airlines means less commitment by airlines and increased risks for airports, for example, in construction of terminal facilities. Less commitment by airlines to routes has implications for air navigation services and their revenue base.

2.7 Many airports must therefore seek to attract new airlines and new types of traffic – for instance long haul operations to secondary airports – and to develop long term partnerships with airlines and alliances to ensure stability of traffic. In specializing to meet new types of traffic and demands of airlines' airports may, for example, dedicate terminals for transfer traffic or regroup alliance partners under one roof. However, airport specialization involves high fixed costs, most of which are unrecoverable if an airline or an alliance abandons a hub where traffic has been artificially created. Once specialized, airports as well as air navigation service providers, need more time and face significant costs to respond to changes than do airlines. Hence the necessity for transparency and consultation in the relationship between airlines and their service providers[1].

2.8 Another notable consequence of airline liberalization and airport commercialization has been the opportunities provided for secondary airports and low cost carriers. The use of such airports by these airlines enables them to by-pass congested hubs and reduce their operational costs; for the airport it may mean development prospects and financial viability.

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[1] *ICAO's Policies on Charges for Airports and Air Navigation Services.* (Doc 9082.6) includes material on transparency and the consultation (and dispute settlement) process.

2.9 The competitive airline environment, with its emphasis on cost reduction, often results in airline pressure on airports and air navigation service providers to reduce user charges while at the same time seeking productivity improvements along with increased efficiency and capacity. Best commercial practices and performance measurement have become a corollary development in airport and air navigation service management.

3. CONCLUSIONS

3.1 From the foregoing discussion the following conclusions may be drawn:

a) for more than a decade, airlines, airports and air navigation service providers have become more commercialized in an increasingly competitive environment. The dynamic development of commercialization and the spread of liberalization will continue to interact and have implications on each other; and

b) while airlines and airport and air navigation service providers are interdependent, their commercialization and privatization in a liberalized environment has a number of competitive consequences and financial implications for both sides. Long term partnerships between airlines and airports are one means to bring stability in that environment. Furthermore, the use of consultation should be an essential part of their relationship.

4. ACTION BY THE CONFERENCE

4.1 The Conference is invited to:

a) note the recent commercialization developments in paragraph 2; and

b) review and adopt the conclusions in paragraph 3.1.

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