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# COMPASS AIRLINES:

## 1 December 1990 To 20 December 1991

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# 1. INTRODUCTION

Economic deregulation of the Australian domestic aviation market came into force on 1 November 1990. After a history of regulated duopoly of air services on the national trunk routes the winds of economic change had finally arrived. The "skies are free" was seen as the symbol of the benefits which now would flow to the travelling public, with opportunities for new airlines to enter the market and compete on price and quality. One airline, Compass Airlines Pty Ltd, was prepared for entry well before November 1990; its Chairman had an extensive knowledge of the two major incumbent operators, Australian and Ansett, and was an owner of a niche market airline, East-West Airlines, before selling it to Ansett.

Compass Airlines was heralded into the market as the people's airline, funded by public subscription, and offering both low fares and high quality service in modern Airbus equipment, servicing the major capitals of Australia. Almost exactly one year on, with no other new entrants, Compass ceased operations. As the first and only new entrant into the market, the debate on the future of Compass aroused intense public interest and there has been a concern by some that this spelt the end of economic deregulation, with a return to higher air fares. Many have asked why Compass should be allowed to be liquidated when it has been the instrument of opportunities for travel, the argument being that the Federal Government should provide financial support because of the benefits derived from economic deregulation.

This paper presents and analyses the evidence and arguments about the collapse of Compass Airlines, focusing attention on the workability of deregulation and on the lessons to be learned by new entrants.  The paper is organised as follows. We briefly outline the background to the formation of Compass Airlines, followed by a sketch of the domestic aviation market prior to and during the period of Compass's operation. The events leading up to the formation of Compass are documented together with a clear statement on the performance of Compass throughout 1991. The collapse of the airline is evaluated from a number of perspectives, notably barriers to entry, competitive strategy, and Compass management. The paper looks in some depth at the controversy over the impact that access to suitable terminals had on the demise of Compass. We conclude with a brief look at the future and new entrants.

# 2. BACKGROUND TO THE FORMATION OF COMPASS AIRLINES

Domestic aviation in Australia has gone from a tightly regulated, but stable, industry to a deregulated one. In the space of one year, the industry has been cut loose from stringent controls and has seen a serious attempt at entry only to result in financial failure. The history of the regulated industry and the legislation applying to it are documented in Brodgen (1968), Richardson and Poulton (1968) and Davies (1971). To set the background for investigating the Compass collapse we summarise the circumstances which enabled the two incumbent airlines to establish a power base, even in the deregulated regime.

## (i) A brief history of the Two Airline Policy (TAP)

In its infancy, the Australian airline industry consisted of subsidised small operators servicing regional markets. After its formation in 1929, Australian National Airways (ANA), with financial backing of shipping interests, began to expand its sphere of operations to the stage where it appeared that a natural monopoly would emerge on the national network. The Labor Government of the day, motivated by a suspicion that monopolistic practices prevalent in shipping would spread to this new and strategic industry, preferred that the public interest be protected through government ownership and unsuccessfully attempted to nationalise aviation. Its next option was to commence its own airline, known for most of its life as Trans Australia Airlines (TAA) and changing to Australian Airlines prior to deregulation.

TAA clearly set out to defeat its private sector rival in the commercial aréna, helped along by whatever support the Government could provide. However, with the election of the pro-business Menzies Government in 1951, aviation policy underwent a sharp change. Still embracing the view that, left to itself, the industry would be controlled by a single airline, the new Government set out to preserve two main airlines, ANA and TAA. The two airline policy thus emerged in 1952 in the form of an Agreement, enshrined under an Act of Parliament, which required the two airlines and the Government to act according to a set of market rules. However, smaller airlines continued to compete freely in interstate services and eventually Ansett Airlines succeeded in taking over its larger rival, ANA. Ansett then became the private sector partner in the two airline policy and quickly moved to take over all of its smaller rivals of any consequence.

The Airlines agreement Act and associated legislation effectively introduced economic regulation of entry to the industry, entry and exit for routes, capacity and fares and required

the airlines to consult on many important areas of commercial importance. The Government protected the two major airlines by making it impossible for a would–be competitor to import suitable aircraft, and it further exempted the airlines from the fair competition requirements of the Trade Practices Act.

The two airline policy was remarkably resilient lasting 38 years. It was amended in 1961, 1972, 1978 and 1981 before the Government announced in 1987 that it would be terminating the Airlines Agreement in October 1990. Of the amendments, the 1981 Act allowed scope for regional airlines to expand on non-trunk routes and permitted them to import jet aircraft where a need could be demonstrated. This concession paved the way for East-West Airlines to move beyond its traditional market in New South Wales. It quickly earned a reputation for its aggressive and innovative approach to competition and gave consumers a taste of what might be possible in a fully deregulated market. When a major review of airline policy was undertaken in 1985, there were widespread calls for economic deregulation.

As a result of this public disquiet about the Two-Airline Policy, the Minister of Transport and Telecommunications announced that regulation of the domestic airline industry would lapse on 1 November 1990 with the abandonment of the TAP. An opportunity for new entrants was created and Compass Airlines was spawned out of this environment.

## (ii) The Economic Effects of TAP

The effect of the TAP was a static industry, dominated by Ansett and Australian, who both secured about half the passenger numbers on the major trunk routes. Forsyth and Hocking (1978) presented a thorough-going analysis of the economic effects of the regulatory instruments that kept the TAP in place. With two virtually identical competitors, competition in the industry became peripheral. The two airlines settled into "a quiet life duopoly" (Kirby 1987). Costs were bloated, fleet selection was sub-optimal, labour was highly unionised and powerful, and most of these "X-inefficiency" costs were passed on to the consumer in the form of higher fares.

The most important restrictions related to entry, capacity and load factors, price control and the nature of competition.

### (a) Entry

Entry into trunk routes and the interstate domestic aviation industry were perhaps the most important restrictions imposed by successive Federal governments. The main trunk routes were reserved for Ansett and Australian. Restriction on entry was backed by controls on the

importation of new aircraft. It was this control on entry that underpinned the rationale for other restrictions (Forsyth and Hocking, 1978).

### (b) Capacity and Load Factors

Every year, the incumbents and the Department of Transport set the levels on the estimated volume of passenger and freight traffic for competitive routes for the following year at given tariff levels. This was called **Determination** and the duopolists were allowed to schedule total capacity on all routes such that average load factors would be 65%, a utilisation rate considered to be commercially viable. If the load factors rose above 65%, then the Department of Transport allowed an increase in capacity after consultation between the airlines. These controls on capacity were a perfect recipe for "a quiet life duopoly" and meant that "chiselling" by any of the majors was counter-productive. The airlines did not seriously engage in schedule competition and profitability was more or less guaranteed.

### (c) Price Control

Price controls were not so explicit, but there was a requirement that firms would not be able to maintain profits above "a reasonable level" for an extended period as this would require tighter price controls. When profits at the then existing levels of "efficiency factor prices and fares" were falling below the "reasonable level", the two airlines would apply for increases which they would normally be granted. Fare increase applications were premised on cost-plus pricing, which allowed for x-inefficiency costs to be passed on to the consumer.

### (d) Competition

The degree of rivalry in the industry was limited. Only in some limited respects were Ansett and Australian genuinely competitive. An example of this limited competition can be witnessed in their parallel schedules. In a fully collusive oligopoly or monopoly, the participants would offer non-parallel flights. The very existence of a "**rationalisation**" committee provided a forum at which the airlines could agree to cut down "costly" competition. There was also collusion on the levels of capacity provided on routes and on the timing of the introduction of new aircraft (Forsyth and Hocking, 1978).

### (e) Inefficiency and High Fares

The most salient weakness of the TAP was the absence of incentives to improve efficiency, to reduce costs, given the cost-plus basis for fare setting, the constraints on competition and the fact that employing more labour would give an urge to one airline as it could provide better service quality. Formby et al. (1990) compared the operating performance of airlines subject to differing degrees of economic regulation and came up with persuasive evidence that regulation produces consistently higher costs, lower productivity, higher fares, fewer

discounts and a more limited choice of services than would result in a more competitive environment. Regulation weakens the incentives to improve economic efficiency and generates incentives for cost-padding. The regulations themselves introduce inflexibilities and a degree of arbitrariness in the allocation of services and the setting of fares.

In Australia, regulation raised prices well above the market clearing level, hence few people could afford air travel before deregulation. The effect of the TAP and its attendant restrictions on entry, capacity and by extension fixing fares above the market-clearing level are captured in Figure 1.

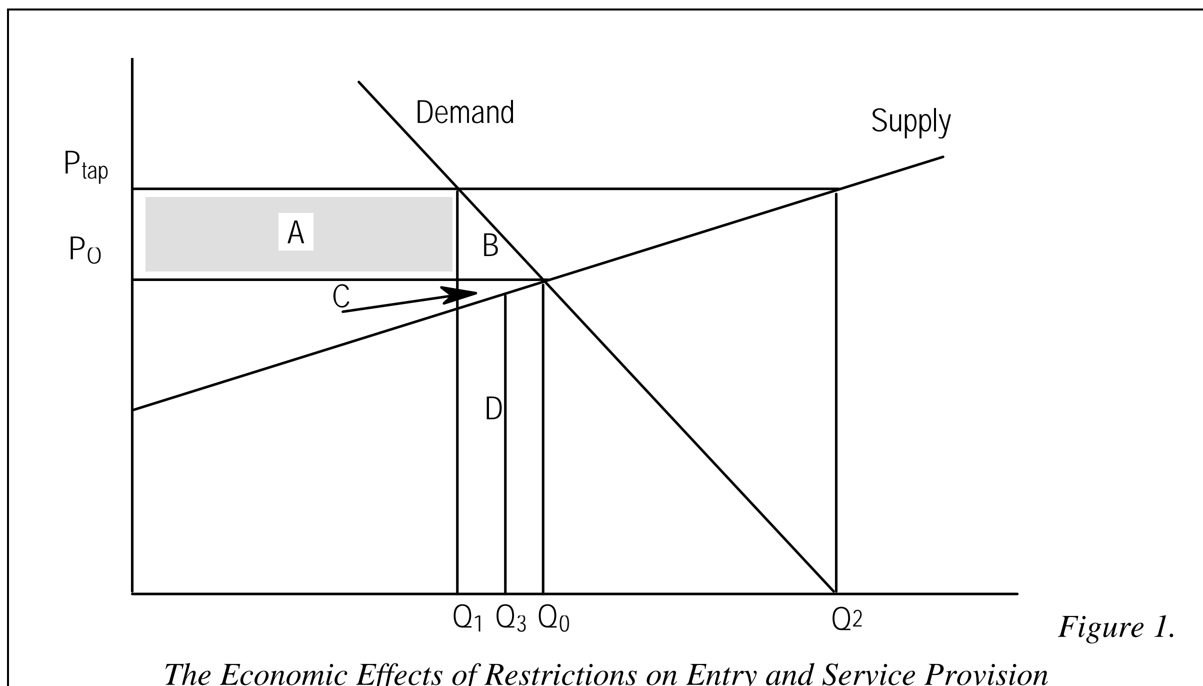



*Figure 1.*

*The Economic Effects of Restrictions on Entry and Service Provision*

At a price $P_{tap}$, the two airlines would have wanted to supply quantity $Q_2$. But this was above the market clearing Quantity $Q_0$ and the market-clearing price $P_0$. Consumers could only afford quantity $Q_1$ at Price $P_{tap}$. At Price $P_{tap}$, the loss of consumer surplus is A + B. Given the presence of capacity and load factor determination, the two majors were able to supply at $Q_3$. The trapezoid "D" represents the cost of superfluous output (x-inefficiency) i.e. slack capacity that the consumers had to pay for in price $P_{tap}$. The rectangle $Q_1$ to $Q_0$ including triangle C represents the stimulatory effect of reducing the price from $P_{tap}$ to the market clearing price of $P_0$.

There was no incentive under TAP to produce efficiently. Forsyth (1987) has argued that regulation made the domestic aviation industry both allocatively and productively inefficient:

> "If as the May Committee argued (May Report 1986), the Australian industry is not offering enough products at the low fare/low quality end of

> the market, which consumers will be willing to pay for, it is **allocatively inefficient** and where prices are above or **below** the marginal costs of supplying the products, then there is allocative inefficiency.",
>
> (Forsyth, 1987, p. 101)

It is against this background of inefficient production and allocation by the aviation industry, that the success or otherwise of deregulation and new entrants is to be judged. An objective of deregulation is to induce improved economic performance through competition. Competition, acting as a restraint on firms should restrict their ability to set prices well above marginal costs, to produce the wrong services and to produce inefficiently. Such competition could come as a result of a large number of firms in the market, the ease of entry and/or exit of firms from the market and the threat of potential entry.

## (iii) The Government's Intention in Deregulating Domestic Aviation

In its plans to deregulate the domestic aviation industry, the Federal government had to dismantle the TAP and by so doing its undesirable economic effects on the industry that we have already alluded to. Its intentions were:

- no capacity constraints were to apply to airlines on trunk routes
- no control on prices unless these were anticompetitive
- no barriers to ownership status save for foreign equity which was to be subject to general foreign investment guidelines as outlined by the Foreign Investment Review Board
- no constraints on new domestic operators or their entry onto trunk routes
- maintenance of the then existing Civil Aviation Authority safety standards
- Qantas to regain interlining rights from July 1988, but no other foreign airline to be given any domestic rights
- Complete relaxation of restrictions on charter flights
- guaranteed access for new entrants to domestic airport terminals and
- involvement of the Trade Practice Commission and the Price Surveillance Authority as the industry watchdogs

(Access Research, 1989).

The anticipated benefits of deregulation were four fold:

(i) providing greater incentives for Ansett and Australian to be more efficient and to respond more flexibly to consumer needs

(ii) to bring about a wider range of fares especially discounted fares

(iii) to ensure continued and stronger growth in leisure travel and more access to flying by Australians, and

(iv) to offer greater variety in types and standards of services provided by the airlines.

Whilst the government's intentions are clear, the collapse of Compass Airlines has put into question the sincerity of these desires and in particular the way the government implemented policy. This issue will be examined in greater detail in a later section. Having established the Federal Government's intentions, we now briefly examine the domestic aviation market just before and soon after deregulation. This is followed by a look at the formation of Compass and its performance in the year of its operation. There are some generic strategies which new entrants could adopt which are of necessity going to relate to the market structure and the behavioural exigencies that the structure circumscribes for firms (Brown, 1989).

# 3. THE DOMESTIC AVIATION MARKET - A BRIEF SKETCH

## (i) Industry Structure

Classical micro-economic theory argues that the degree of competition in an industry is largely the function of market structure. Firm concentration as measured by the standard industrial classification index (SIC) measures the amount of rivalry in an industry. Theories of competition and business strategy have largely taken up the structure-conduct-performance paradigm to explain competitive behaviour within the market in contrast to competition for the market (i.e. contestability). Porter's (1980) competitive strategies for instance are based on the structural analysis of industry. The structural determinants of rivalry are:

- the number of competitors in the industry
- the degree of new entry in the industry
- the strength of industry demand
- the degree of excess (slack) capacity
- the homogeneity of firm's cost structures, technology in use and the size of firms
- barriers to entry and exit, and
- the degree of fixed or sunk costs.

In the Australian domestic aviation market, the major players on the trunk routes prior to deregulation were Ansett and Australian. Eastwest, owned by TNT - the parent group of Ansett - concentrated on selected routes, mostly the niche leisure market. With the statutory three years notice of the termination of the two airline policy (TAP), Ansett and Australian started to prepare themselves for 1990 and took pre-emptive action on a number of fronts.

Before Compass' entry, the market was characterised by concentration where Ansett and its associates dominated with a 59% share of the passenger numbers uplifted, compared to Australian's 44% on major trunk routes (Baussman, 1989). Australian had a stronger focus on the trunk routes, whereas Ansett, while equally strong on the trunk routes, was even more

strongly represented on regional routes. While the Ansett group held 55% of the domestic uplift (DOTC, 1990), it flew unopposed by Australian on many regional routes. Where there was direct competition with Australian on trunk routes, Australian had the edge since 1984 in both passenger numbers and fare values paid (DOTC, 1990). Figure 2 shows the relative market shares in December 1990 and a year later in December 1991.

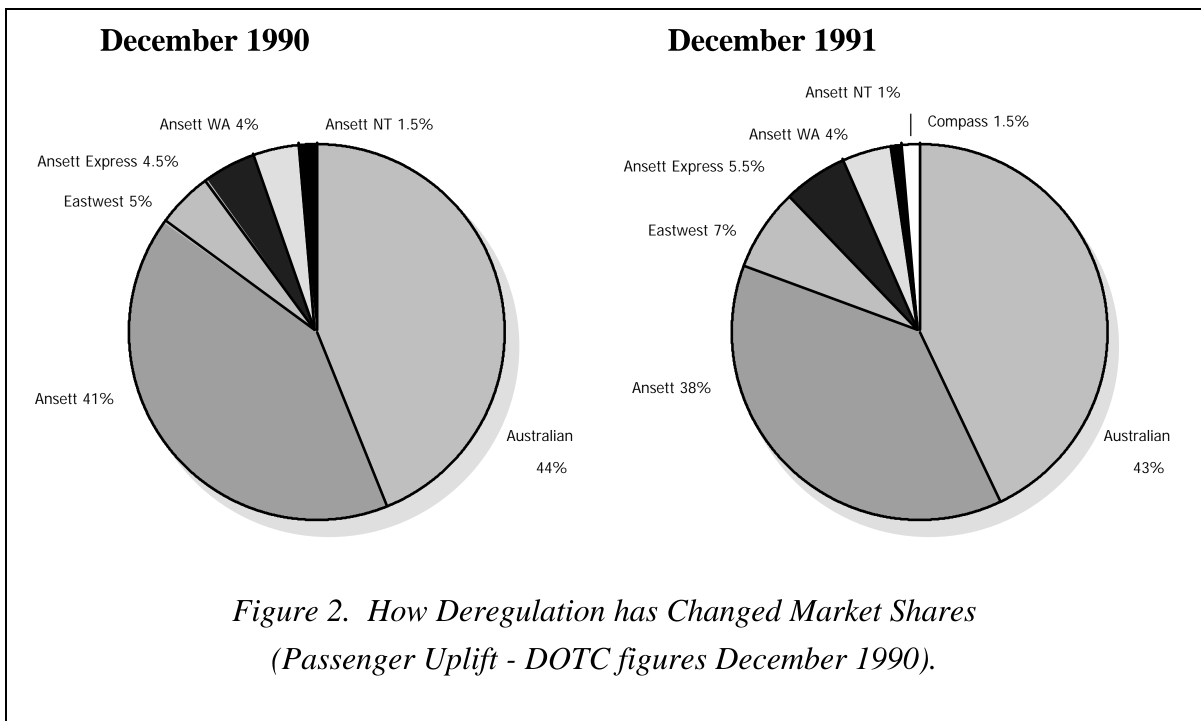
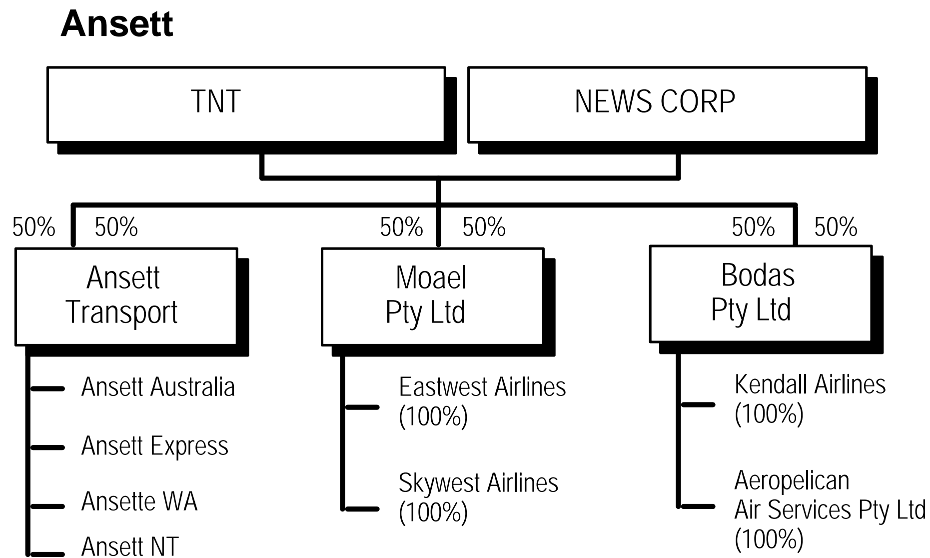



*Figure 2. How Deregulation has Changed Market Shares (Passenger Uplift - DOTC figures December 1990).*

The ownership structures of both majors is summarised in Figure 3. The Ansett group comprises Ansett Australia, and the regional airlines: Ansett Express, Ansett WA, Ansett NT and the leisure airline Eastwest. Australian owns Sunstate Airlines (Qld), Sunstate Airline Mildura, Australian Regional Airlines and holds 42% of Eastern Australian Airlines. It also has a close commercial relationship with Hazelton Airlines. A number of other smaller operators make up the regional market sector.



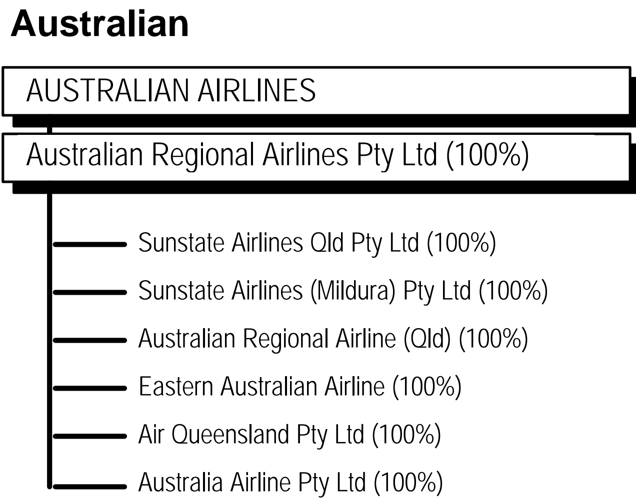




*Figure 3. Ownership Structures of the Majors*

The major airlines had strong links with the travel industry, a number of resorts and hotels, car rental companies, retail chains and tour wholesalers. Figure 4 summarises the relative affiliations and ownerships.

| **Facilities Owned/Aligned** | **Ansett** | **Australian** |
|---|---|---|
| 1. **Hotels & Resorts** | Gateway Hotels<br>Hamilton Island<br>Hayman Island<br>South Molle Island<br>Southern Pacific Hotels Corp. | Bedarra Island<br>Brampton Island<br>Dunk Island<br>Great Keppel Island<br>Hilton<br>Lizard Island<br>Sheraton<br>Whitsundays<br>Wilderness Lodge |
| 2. **Coach Companies** | Bus Australia<br>Pioneer | Pioneer<br>Newmans |
| 3. **Car Rental Companies** | Avis<br>Trans-National Transport | Hertz<br>Budget |
| 4. **Tour Wholesalers** (owned/aligned) | Ansett Holidays<br>Destination Australia | Australian Holidays<br>Jetset<br>Traveland |
| 5. **Retail Chains** (owned) | ANZ Travel<br>Coles-Myer Ansett Travel<br>Concorde Travel<br>David Jones Travel<br>Elders IXL Travel<br>Show Travel<br>Steward Moffat<br>Traveland | Own outlets (53)<br>Australian Airlines<br>Westpac Travel |
| 6. **Retail Chains** (aligned) | Jayes Travel<br>Metro Travel Group<br>Own outlets (54)<br>Thomas Cook<br>Traveland Coles-Myer<br>Wiandana TTP | American Express<br>Harvey World<br>Jetset<br>National Travel<br>Thomas Cook<br>Travelstrength<br>UnitedTrav.Ag. Gp |
| 7. **Consolidations** (CRS system preferred) | Metro Travel<br>Ansamatic<br>Southern Cross/Travelex | Concorde<br>Galileo<br>Southern Cross |
| 8. **Other Affiliations/ alignments** | Aero Pelican<br>Ansett NZ | British Airways<br>Air New Zealand |

| | | |
|---|---|---|
| | Ansett Wridgeways<br>Concorde<br>Diners Club<br>Eastwest<br>Kennards<br>Overseas Airlines<br>TNT Group | Singapore Airlines<br>UTA<br>Canadian Airlines<br><br><br>Source: King (1991) |

*Figure 4. Trade Industry Alignments and Affiliations in Australia*

Prior to deregulation, Australian had a stronger focus on the business traveller market. This was due partly to the availability of business class seating and the targeting by the airline for these high yield passengers. Ansett until late 1990 did not offer a business class equivalent to compete with Australian.

Fleet numbers and type play an important role in determining the routes and market segments that a carrier can compete in effectively. Aircraft type dictates the minimum route density that can be serviced while being able to maintain profitable load factors and the requisite service frequency. Larger planes are less cost effective on an available seat kilometre cost basis on thinner routes but are more profitable on denser routes. Both Ansett and Australian began a large scale re-equipping programme before deregulation, updating their fleets so as to achieve operating economies and to enhance service levels for the lucrative business travel market. This timing was also designed to preserve "**fighting funds**" for use in the early days of deregulation.

## (ii) Raising the Barriers to Entry Repositioning by Incumbents Prior to Deregulation

The three years notice of the termination of the TAP gave incumbents ample time to prepare for deregulation and to take pre-emptive action, to reduce the risk of entry to them on the trunk route network. There is a common thread that runs through most of the strategies that the incumbents adopted on the dawn of deregulation. Of special interest:

- both concentrated on building a strong and secure market base before deregulation. They began a quick retreat from routes that would not be viable and they went from servicing 95 airports to 68, leaving the abandoned routes open to commuter or regional operators (Sandilands, 1991).

- Australian embarked on a staff rationalisation campaign, aiming to reduce its staff numbers by 1000. This rationalisation continued even after deregulation with voluntary redundancies being offered. Ansett was more secretive about its staff reductions, preferring to use natural attrition and staff redeployment techniques.

- The pilots' dispute which effectively closed-down the airlines for 6 months offered an opportunity to trim pilot numbers and served notice that the airlines would take a tough stand in industrial relations.

- There was a heightened sense of urgency by both majors to become flexible enough to react to any competitive contingency if needed, to ensure that they were able to protect their business traveller customer base, and to change their internal systems to relate to new authorities (Access Research, 1989).

- Both airlines slightly altered their pricing strategies. They ran advertising campaigns offering discounts on selected routes with some conditions. For example, there were discounts of up to 45% off the economy fare, special discounts for specific market segments such as the over-60s, and off-peak, late evening and night flight discounts were introduced. The Perth to eastern capitals routes were targeted since these had historically been highly priced and offered the most marketing impact in terms of absolute fare reductions.

- Ties with commuter airlines were strengthened in a bid to secure passenger feed from intra-state routes and to provide a low cost option for serving thin routes and to forestall commuter airlines from upgrading themselves to trunk competitors after deregulation.

- Yield management systems were upgraded so as to improve the information data base for management decisions and the targeting of markets effectively. Both joined the Galileo Computer Reservation System (CRS) and in so doing, established it as the pre-eminent CRS for the domestic market.

- The incumbents strengthened ties with travel agents, hotels and car hire firms. For instance, Ansett acquired Traveland, ANZ Travel and formed a partnership with Coles-Myer to establish the Coles-Myer Ansett travel agency. It has preferred carrier status with MetroTravel. In addition, Ansett offered to cover merchant fees for major credit cards and offered a 10% override payment to agents to use a selected credit card (Harrington, 1991). Earlier, Australian had offered passengers the payment of merchant fees when American Express credit is used for the ticket purchase. Australian also acquired Westpac Travel as well

as having already enjoyed a longer and better association with most travel agents.

There were also some strategies that each of the majors adopted that have not been mimicked exactly by the other. **Ansett** introduced a substantial discount fare structure offering a wide range of fares and services specifically aimed at moving the airline from its past business passenger focus to serve the entire market including leisure-travel. This involved a finer segmentation of the market by retaining some conditions on discount fares so as to minimise spillage from business travellers onto its leisure market offers, and offered business class initiatives such as two abreast first class style. Eastwest increased its focus on the leisure market.

**Australian** concentrated on developing a wider market appeal, especially expanding its penetration of leisure travel, while still retaining its strong focus on the business travel centre. It reduced six-across business class seating to 4 seats and opened an airport conference centre at Melbourne. In 1990, Australian developed new fare structures in an effort to maintain market dominance under deregulation, based on market research and the use of a yield management system. The airline claimed that its yield management system enabled it to pinpoint "soft spots" in the network and to provide products which maximised revenue on those routes. Australian opened more overseas offices, taking the number to 13 offices, 9 general sales offices and a number of general sales agents. It expected this strategy to increase its market of inbound visitors from 10% to 20-25% within the next five years. These initiatives were targeted at the Asian countries such as South Korea, Thailand and Taiwan.

The net effect of the incumbents' strategies was to raise barriers to entry. But the most significant firm-created barrier to entry and one that was to shape the nature of competition in a deregulated environment relates to terminal leases extended to the incumbents. In December 1987, just before the handover of airport management to the Federal Airports Corporation (FAC), the Federal Government and the incumbents renegotiated leases for terminal facilities at Sydney, Melbourne, Perth, Adelaide, Launceston and Coolangatta airports. The new lease conditions for Sydney also covered expansion land around the existing terminals, with the term for Sydney leases being 20 years for the premises and eight years for the expansion land where it has been developed (BTCE, 1991a).The Federal Government required the incumbents to provide gates at their terminals to new entrants, two each at Sydney and Melbourne, one each at Adelaide, Perth and Coolangatta and one at Launceston by Ansett only. These leases have been widely criticised on the grounds that

they have given Ansett and Australian considerable market power. We examine the issue of terminal leases in greater detail in a later section.

The firm-created barriers to entry raised the stakes for intending new entrants and the competitive strategies they could use were circumscribed. Starting from scratch in Australia's commercial aviation environment placed Compass at a distinct disadvantage. Not only was there the question of adequate funding in terms of start-up costs, but also the need to provide for long term losses and "**fighting funds**" in order to survive the retaliatory pressures from incumbent airlines. Besides, global demand for new or leased aircraft was bullish when deregulation came into force. The new entrants had to invest heavily in advertising, not only of their products, but corporate identity, building awareness, image development and route promotion.

## (iii) Possible Strategies For Entrants (Given the Barriers to Entry)

In a study completed for the Australian Federation of Travel Agents, Access Research (1989) argued that new entrants would have to stay small and low priced for the business market on major trunk routes and to concentrate on niche marketing and the development of new routes. Success would depend on the creation and servicing of new market niches, operating around the majors (flanking strategy), and to forge links with international airlines so as to tap the inbound tourism market. The convention market was also identified as a profitable niche. Above all, Access Research believed that the new entrants would have to stay low cost with a low investment intensity.

The simplest strategy open to new entrants was that of undercutting the majors' fares. But the US experience of such airlines as People's Express showed that price cutting, on its own, is problematic. A cost leadership strategy (whose focus in essence is to compete on price as the major marketing tool) is not appropriate where there is actual or perceived product/service parity and channels of distribution are critical factors for competitive advantage. Brown (1989) considers a "head-on strategy" with a direct frontal attack to beat the competitor through sheer force. This is risky strategy and it requires good products/services, heavy marketing support and substantial financial resources to enable a prolonged counter-attack by competitors to be rebuffed. A relative advantage in resources, commitment and management focus is required to win a head-on encounter. It would appear that Compass to an extent chose this strategy but had none of the requisite resources needed to win.

# 4. *ENTER COMPASS! ITS PERFORMANCE IN THE FIRST TWELVE MONTHS*

Compass Airlines was the first entrant and the first casualty of the deregulated domestic aviation environment. It is necessary to analyse the history of its operations in the first twelve months if its performance is to be fairly evaluated. Such a longitudinal approach will help us understand what went wrong with Compass in its maiden year. The Compass calendar, a chronology of the major events and fare initiatives, is given in Appendix A.

## (i) Formation of Compass - the Planning Stages, and Strategies Chosen

Compass Holdings Limited was incorporated on 2 July 1987, with its prime objective to establish and operate an Australian domestic airline through its wholly owned subsidiary Compass Airlines Pty Limited (Ferrier, 1992). The main motivation for its formation was that the Chairman, Bryan Grey felt that there was room to under-cut the incumbents - whose efficiency had become impaired under the protection of the TAP. The pilots dispute also left some residual ill-feeling in the market place about Ansett and Australian.

To finance the company, Bryan Grey initially had a figure of $100 million in mind, but failed to convince investors about the viability of such a venture, and went down to $85 million, still seeking placement with institutional investors. He failed to get this support and finally had to settle for a public flotation of $50 million underwritten by Potter Partners Underwriters Limited. In the event, $65 million was raised from the public, as well as $5 million of shares issued to C. Bryan Grey. The table showing equity participation appears in Appendix 2.

### (a) Mission Statement and Market Positioning

The Chairman of Compass in his letter to shareholders spelt out the strategy and market positioning of Compass vis-a-vis its competitors.

> "Compass is designed to operate on an efficient cost structure stemming from its one aircraft type operation and in particular the operation of five large aircraft servicing only seven major airports. Compass is largely targeting an incremental market generated by its lower fare structure."
>
> (Compass Prospectus, 1990)

### (b) Proposed Strategies at its Formation

An important question is whether Compass' demise was due to inadequate strategy formulation or a failure to stick to its proposed strategies. On formation, its **fleet and route portfolio** involved operating five single class Airbus aircraft between Sydney, Melbourne, Adelaide, Perth, Brisbane, Coolangatta and Cairns. The routes were perceived as offering the greatest profit potential and public recognition and they had the highest densities. The **market segments and schedules** considered on the major trunk routes in Australia were peak business traffic (7am - 9am and 4pm - 9pm), off-peak schedule operations (9am - 4pm), and curfew or back of the clock (9 pm - 7am). The **pricing policy for each segment** was intended to penetrate these markets with the following fares:

- Peak and Off-Peak fares: - 80% of the then current standard economy fare offered by Ansett and Australian.
- Curfew fares: - 50% of the then current standard economy fares of the majors and
- Curfew services to be offered on the Sydney - Perth, Melbourne - Perth and Melbourne - Cairns routes.

The pricing strategy was premised on the assumption that the majors were limited in their ability to match the Compass offers since their cost structures were supposedly higher. Their uncompetitive operating costs were supposedly emanating from mixed aircraft fleets, complex rostering systems, multiple crew locations and aircraft types with higher operating costs than Compass' on a per seat kilometre basis. The pilots' dispute had already cost the incumbents dearly; Australian Airlines alone was reported to have lost more than $150 million as a result of the dispute. It was also projected that Ansett and Australian would be limited in their ability to subsidise discounting on the major routes entered by increasing fares on the routes on which Compass would not compete.

### (c) Operations Planning

Compass was involved in aircraft lease negotiations even before obtaining an Air Operators Certificate. It succeeded in securing operating leases for Airbus aircraft with Polaris Holding Company (a subsidiary of General Electric (USA)), Monarch Airlines (UK) and Canadian Airlines (Canada). The Airbus A300 - 600R aircraft requires two flight crew and 8 cabin staff. On the basis of five aircraft, Compass was to employ a flight crew and cabin staff of 232. It had a target of 690 annual hours of flight crew utilisation. The flight and cabin crew were to be based in Melbourne.

Maximum use of traffic employees was planned in off-peak periods by giving them the responsibility for processing documentation after aircraft departures, thus eliminating the need to transfer documentation to accounting departments. Multiskilling is a sensible policy for a start-up. All technical maintenance work was to be contracted out to Hawker Pacific Pty Ltd who would perform it at Brisbane Airport in a hangar complex constructed by Compass. The contracting out of jobs was a strategy to limit capital requirements (and perhaps to provide flexibility for expansion).

Compass chose the **SABRE** computer reservation system developed by American Airlines which is used and marketed in Australia by Qantas under the name "Fantasia". It was reluctant to use the Galileo system that was being used by the majors. Compass "chose" to be a sub-lessee of Australian for terminal access at Sydney, Melbourne and Adelaide. Negotiations for terminal access at Perth were unsuccessful. At Brisbane it used FAC facilities and at Cairns the Airport Authority also provided terminal facilities. The opportunity to lease terminal facilities, albeit inferior space in the view of Compass, rather than having to build them has been argued by Compass as a major reason for its collapse. This competitive disadvantage needs to be evaluated against the financial benefit gained by not having to invest in its own terminal.

### (d) Financial Forecasts

Perhaps the most important selling point of the prospectus and the culmination of all the planning since the formation of Compass Airlines was the financial forecast. This was premised on the then on-going negotiations between Compass and various outside parties and they assumed the following:

- the issue of an Air Operators Certificate
    - the lease of five Airbus A300-600R aircraft in accordance with the timetable agreed to

- the continuation of the executive service agreement with C. Bryan Grey
- crew productivity and rostering out of Melbourne
- maintenance based in Brisbane and sub-contracted to Hawker Pacific Pty Ltd
- use of the SABRE reservation system and
- FAC approval of terminal access.

Commencing in 1991, an average passenger load factor of 60% with no growth in market share or load factors over the forecast period of five years was assumed. Fares were to be discounted to 80% for the peak and off-peak, and 50% for the curfew of the majors' undiscounted standard economy fares ruling at any particular date of operation. A dividend payout policy of 75% of retentions at each semi-annual dividend payment was planned together with a debt-equity ratio after June 1991 of no more than 30%.

Arthur Anderson and Co, independent Chartered Accountants agreed with Compass' forecasts, stating:

> "We believe a forecasted average passenger load factor of 60% is reasonable and based on the recent high load factor achieved throughout the industry; the strategy of operating only on major trunk routes; the discount pricing strategy and the choice of aircraft."
>
> (Compass Prospectus, 1990, pp.27)

## (ii) Financial Performance in the 12 Months of Operation

The Ferrier Hodgson and Co's "Provisional Liquidator's Statement to Interested Parties", dated 8 January 1992 gives a holistic picture of Compass' financial performance for the twelve months ended 20 December 1991. Given that Compass was only into its first year of operation, any comparisons with past performance (trend analysis) or with other companies in the industry (inter-company comparisons) are precluded. The only realistic yardstick for measuring its performance is to use the financial forecasts as presented in the Prospectus. We therefore compare the forecast revenue in the prospectus with the actual results as at the end of November 1991 (Table 1). Figures for the twenty days of operations in December are not yet publicly available.

## Table 1. Comparison of Actual Financial Results with Forecasts

| Financial Year 1990/91 | Financial Year 1991/92 | | Operations Year Average (Actual) | | |
|---|---|---|---|---|---|
| **Prospectus** | **Actual** | **Prospectus** | **Actual** | **Actual to Nov 1991** | |
| **$M** | **$M** | **$M** | **$M** | **$M** | |
| Load Factor | 60% | 57% | 60% | 74% | 66% |
| Yield | $184 | $150 | $191 | $113 | $132 |
| Revenue | $153 | $ 72 | $372 | $ 97 | $ 85 |

Source: Ferrier Hodgson and Co; 1992.

Despite better than forecast load factors, Compass' yield was eroded by deep discounting. Trading losses for the year of operations amounted to $43.2 million:

| | $M |
|---|---|
| Trading loss from 1 Dec 1990 to 30/06/91 | 16.5 |
| Trading loss from 1 July 1991 to 30/11/91 | 26.2 |
| Bad debts as at 30/11/91 | 0.5 |
| | 43.2 |

Source: Ferrier Hodgson and Co; 1992.

The forecast profits for the year of operations was $72.451 million compared to an operating loss of $43.2 million.The liquidators prepared a statement of assets and liabilities as at 20 December 1991, in two formats; one with Compass as a going concern and, second with Compass as a ceased business (Table 2).

**Table 2. Compass as a Going Concern and a Ceased Business.**

| Going Concern Values | | Ceased Bus. Values | |
|---|---|---|---|
| **Assets** | | **$M** | **$M** |
| Sundry debtors | - trade | 3.3 | 3.3 |
| - | Australian Airlines | 5.1 | 5.1 |
| - | Security deposit | 1.6 | 1.6 |
| Inventory | - Stock and Spares | 8.2 | 8.2 |
| - | equity in Airbus parts | 5.3 | 0.0 |
| Furniture, Plant & Equipment | | 5.4 | 5.4 |
| Leasehold Improvements | | 1.8 | 1.8 |
| Prepayments | | 8.5 | 8.5 |
| Equity in Leased Plant & Equipment | | 3.9 | 3.9 |
| Deferred Expenditure | | | |
| - | current | 7.5 | 0.0 |
| - | pre-operating | 8.3 | 0.0 |
| - | routes establishment | 14.1 | 0.0 |
| - | training | 5.5 | 0.0 |
| Cash on deposit as security for | | | |
| - | aircraft lease | 19.6 | 19.6 |
| - | aircraft purchase/lease | 7.7 | 7.7 |
| | 105.8 | 65.1 | |
| **Liabilities** | | **$M** | **$M** |
| Employees Claims | | | |
| - | Wages & holiday pay | 2.2 | 2.2 |
| - | redundancy & termination pay | 0.0 | 4.6 |
| Deputy Commission of Taxation | | 1.8 | 1.8 |
| Computers under Lease | | 0.0 | 1.2 |
| Aircraft Engines Under Lease | | 0.0 | 1.5 |
| Unsecured Creditors | | | |
| - | unearned revenue | 38.0 | 38.0 |
| - | Compass Holding Ltd | 70.0 | 70.0 |
| - | FAC/CAA | 17.0 | 17.0 |
| - | others | 22.0 | 22.0 |
| Estimated Damages - Aircraft Leases Cancelled | | 0.0 | 59.0 |
| Estimated Damages - if Plane Purchase Orders Cancelled | | 0.0 | 19.0 |
| | **151.0** | **236.3** | |
| **Estimated Deficiency of Assets to Meet Liabilities** | | **45.2** | **171.2** |

*Source: Ferrier, 1992*

As a business venture, Compass failed dismally as reflected in some selected **financial ratios**. **The ratio of sales to total assets** (or the productivity ratio) is an indicator of how the company is turning over its assets and the margin it makes on each sale. Anything less than

one indicates that the company's asset utilisation is below par. Using the 30 June 1991 figures (because of the unavailability of the asset figures as at 20/12/91), the ratio was 0.51 (= 70.944M/136.691M).

**The ratio of earnings (before interest and taxes) to sales** indicates the margin the company is making in sales. For Compass this ratio as at 20/12/91 was - 0.256 (=-43.2M/169M). The margin was actually negative, primarily because of the heavy discounting wars. A low asset turnover ratio and a low profit margin is a fatal combination; a higher asset turnover might in some cases compensate for lower profit margins - as is usually the case in the retail business. There are many other financial ratios that would indicate poor performance on the part of Compass, but we have seen ample evidence that Compass' financial performance was not satisfactory.

## (iii) Other Performance Indicators - Operations, Market Share and Service

It is too harsh to evaluate Compass' performance simply on the basis of the bottom line. The entry of Compass saw a substantial change in the structure and operations of the Australian domestic airline industry. To some extent, it provided greater flexibility in areas such as pricing and route structure. The structure and level of operating costs has changed since economic deregulation, especially after Compass' entry. Costs have been cut by such initiatives as reduction in staff numbers at Australian and Ansett as both have sought productivity increases. The majors have been forced to rationalise their fleet selection procedures; Australian for instance has sold off its vintage B727-100 aircraft and it claims to be achieving better aircraft utilisation.

The entry of Compass and the new competitive regime introduced heterogeneity in services offered and increased capacity but, with yields driven down, the players had to consider cutting costs. The Bureau of Transport and Communications Economics (BTCE, 1991) in its report on the first year of deregulation claims that Compass had a distinct cost advantage over its competitors. This was a commendable performance, but one that does not necessarily guarantee sustenance as was demonstrated in the USA.

### (a) Compass' Cost Advantage

The BTCE estimated that Compass' direct operating costs were 5.3c per available seat kilometre (ASK) compared to the majors 8.5c per ASK (BTCE 1991). The longer average

stage distance and the economies of operating larger aircraft were all factors that imparted Compass with its cost advantage. Table 3 summarises the estimated direct operating costs for Compass and the majors.

**Table 3. Estimates of Direct Operating Costs for Compass and the Main Incumbents (cents per ASK).**

| | Compass | | | | | |
|---|---|---|---|---|---|---|
| | | Base | Utilisation | Stage (Compass) | Average (Majors) | Incumbents |
| **Capital** | | 1.36 | 1.74 | 1.81 | 1.64 | 1.56 |
| **Fuel** | 0.70 | 0.70 | 0.73 | 0.71 | 0.88 | |
| **Maintenance** | | 0.89 | 0.89 | 0.93 | 0.90 | 1.64 |
| **Crew** | | 0.32 | 0.34 | 0.35 | 0.34 | 0.74 |
| **Government** | | 1.44 | 1.44 | 1.60 | 1.49 | 1.90 |
| **Other** | | 0.56 | 0.56 | 0.70 | 0.61 | 1.55 |
| **Total** | | 5.26 | 5.65 | 6.11 | 5.69 | 8.52 |

Source: BTCE, 1991a

The incumbents had a comparative advantage only as far as capital costs were concerned. In terms of direct operating cost components, Compass' aircraft had higher capital costs per seat kilometre than incumbent airlines (because they are newer), but were much more fuel efficient and less costly to maintain. Cost data, whilst useful as far as analysing the validity of Compass' competitive strategy, has to be set against revenue-earning performance. In the USA, the new entrant airlines possessed many cost advantages over the established airlines (Bailey, 1985), but these were not sufficient to outweigh the other advantages of the established airlines, in the longer run.

Although Compass had a cost advantage conferred to it by its aircraft size on the routes that it competed, Australian and Ansett also used their Airbuses on the same routes. The majors' strategies therefore dampened Compass' cost advantage. The incumbents also had larger networks and thus reaped economies of scope, scale and administration. Their higher frequencies, more flight connections and generally better scheduling attracted "pin-stripe" traffic, which although more costly to service, translates to a higher yield revenue for only marginal increases in costs.

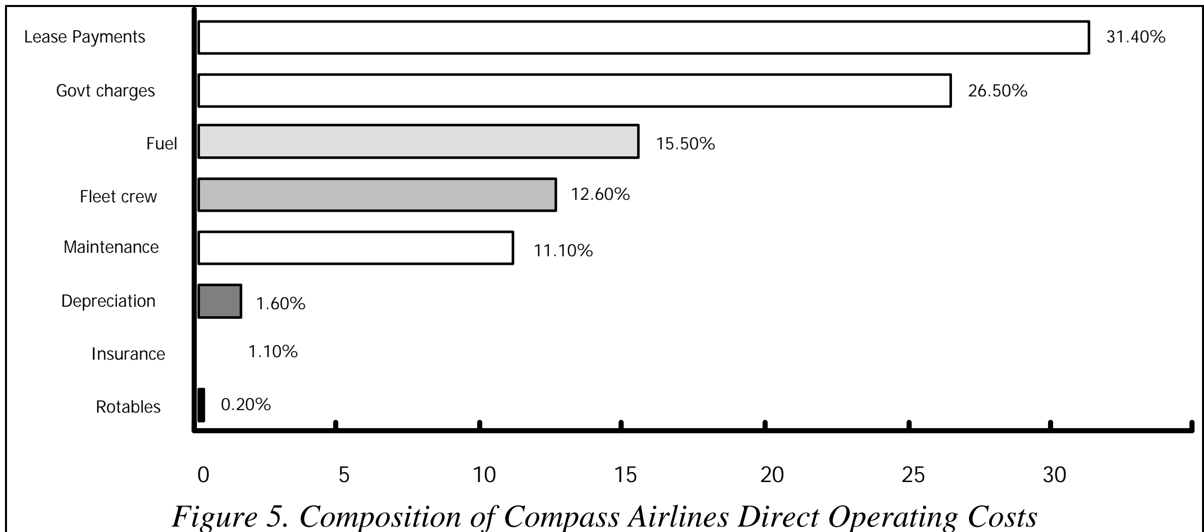



*Figure 5. Composition of Compass Airlines Direct Operating Costs*

Aircraft lease payments, constituting the largest direct operating cost (Figure 5), were a serious drain on Compass' cash as they were paid on a monthly basis. Although Compass was able to cover its direct operating costs, it was not able to cover total average costs (Figure 6). The graph below shows how Compass' revenues fell short. The decline in profitability was reflected in a deteriorating yield despite an improving load factor and passenger numbers uplifted. The operating profit in June 1991 was an aberration that can be attributed to Compass' decision to capitalise route establishment costs which amounted to $13 million.

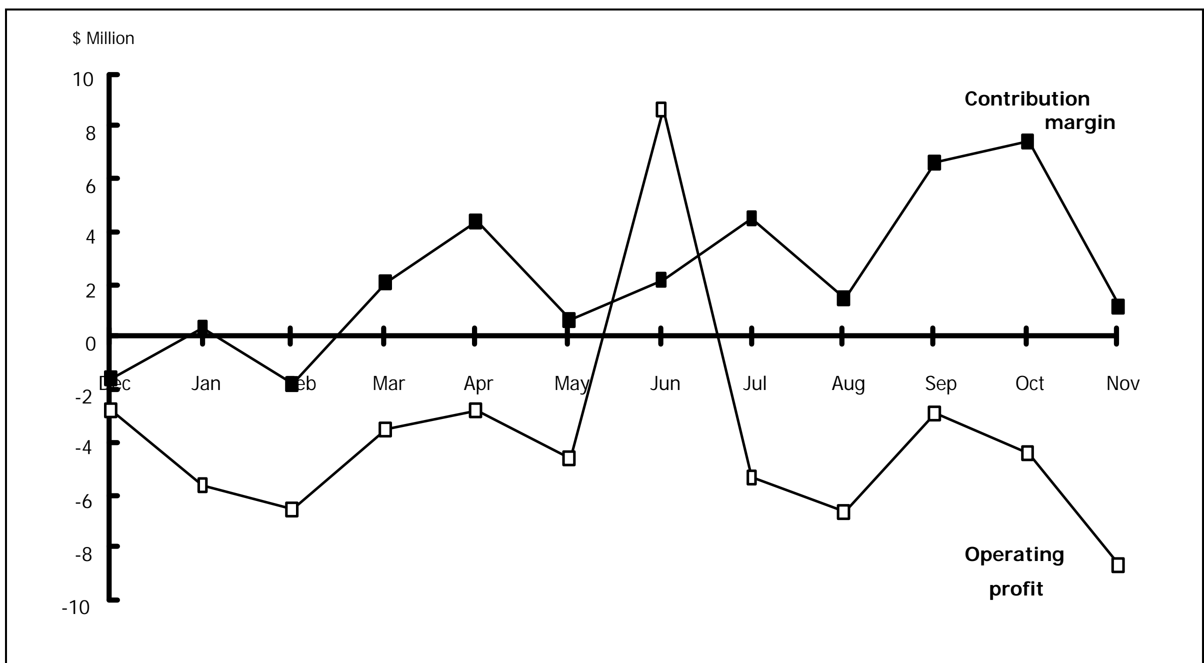


*Figure 6. Compass' Operational Performance: Operating Profits and Contribution to Indirect Operating Costs and Overheads (Dec 1990 to Nov 1991)*

## (b) Passenger Uplift and Load Factors

Figure 7 gives the load factor growth on a monthly basis from 1 December 1990 to 30 September 1991. Up to 30 June 1991, Compass carried 510,000 sector passengers at an average load factor of 61% and, for the five months to 30 November 1991, 835,000 passengers were carried at an average load factor of 74%, all above the prospectus forecast of 60%. It would have been desirable to compare Compass performance with that of the majors but load factors nationally are aggregated. Despite the high loading, Compass' fare discounting eroded passenger yields and thus profitability.

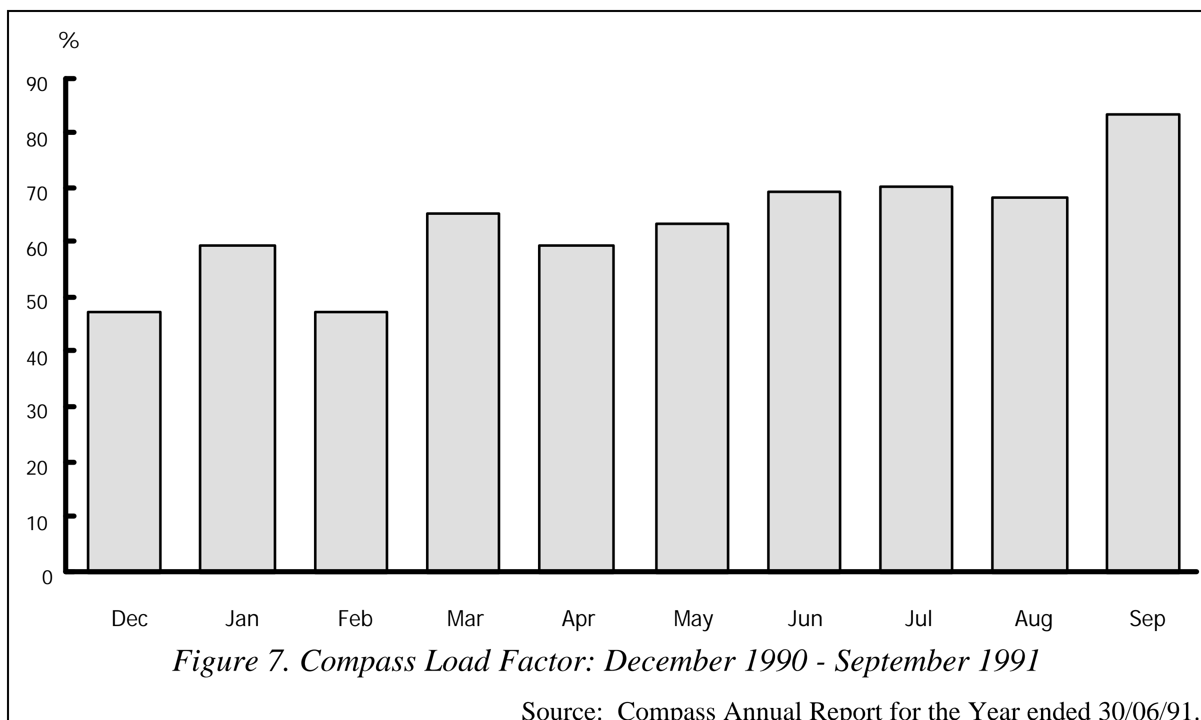



*Figure 7. Compass Load Factor: December 1990 - September 1991*

Source: Compass Annual Report for the Year ended 30/06/91.

With an optimal pricing regime in place, an increase in load factor should translate to improvements in revenue. Compass' pricing was such that it stimulated the market and improved load factors but there was no corresponding increase in yield. Figure 8 illustrates a hypothetical yield/load factor trade off. At higher load factors, achieved through discounting, the yield drops from $Y'_1$ to $Y'_2$. Premium fares could fetch a yield of Y at a lower load factor and lower fares would fetch a yield of $Y'_3$ with a higher load factor. The

scope for increasing both load factors and yield on national trunk routes by a new entrant facing competition is limited.

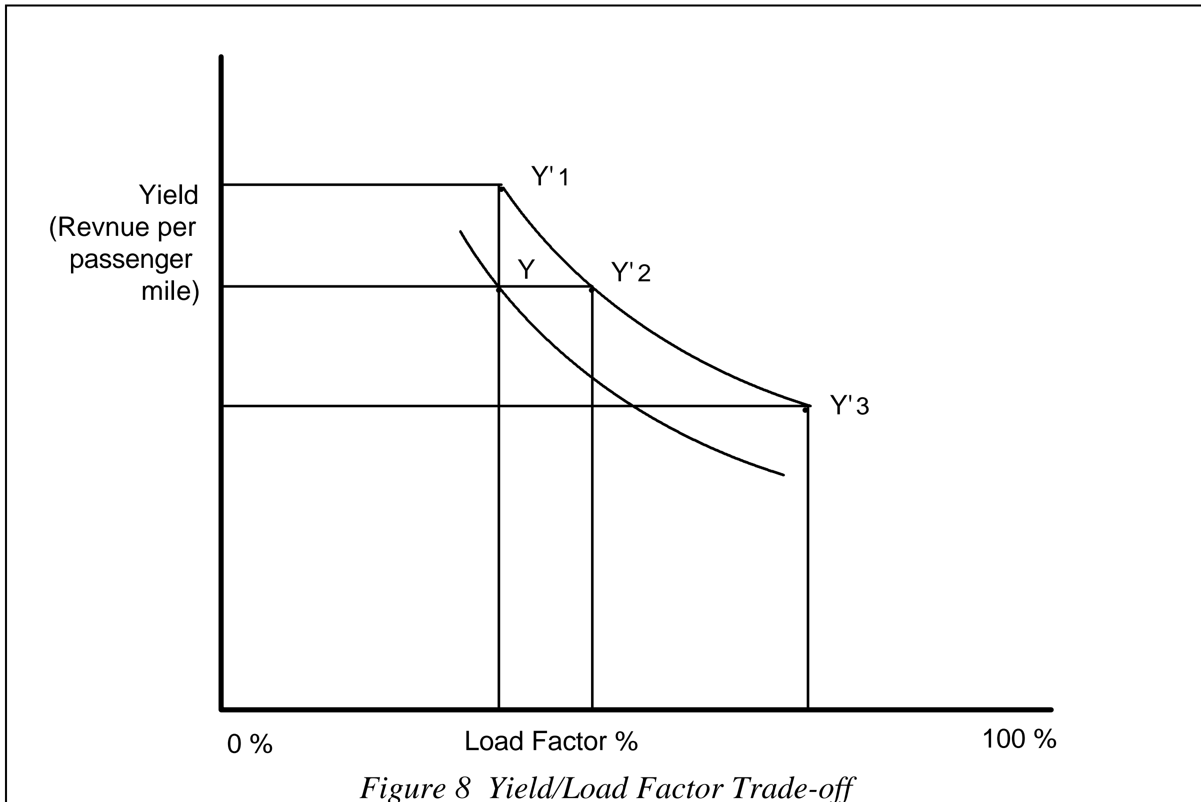



*Figure 8 Yield/Load Factor Trade-off*

## (c) Market Share

For the quarter ended 30 September 1991, Compass' market share measured in passengers uplifted was 24.6% on routes which it operated (Figure 9). Its market share nationally measured by the number of passengers uplifted and discharged was 12.2% as at 30/09/91. The proportions of the market share Compass gained as a direct result of stimulation of aggregate demand or the part it obtained by passengers switching from the majors are not publicly available. There is no doubt though that Compass stimulated demand on the tourist destinations such as Cairns and the longhaul routes such as Sydney/Perth.

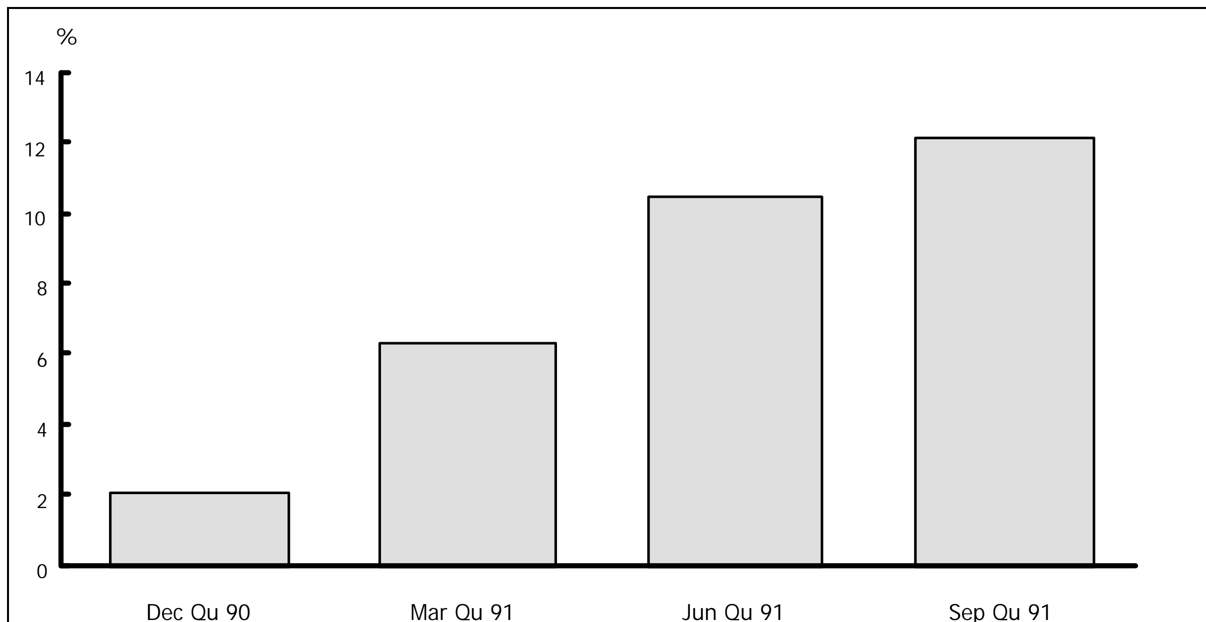



*Figure 9. National Market Share of Compass - December Quarter 1990 to September Quarter 1991.*

Source: Compass Annual Report for the Year Ended 30/06/91.

## (d) Service

The calibre of service offered by Compass was recognised as high. This was evidenced by the company winning the Civil Aviation Authority's "Airways Award For Excellence", as the best Airline amongst domestic and international airline services in the Australian market.

Despite Compass' impressive load factors, market share growth, public goodwill, service excellence and cost efficiency, it still collapsed. The company's operating results show the "punishment" suffered by it for the few months delay in reaching a four aircraft fleet due to late delivery of two new aircraft from Airbus Industries to Monarch Airlines. The company had to lease, at unfavourable rates, an Airbus from Air Niugini over the Easter period and it had difficulties in accessing terminal space when Australian failed to provide facilities of **“a type normally utilised by themselves”** at Perth, Adelaide, Melbourne and Sydney (Compass Annual Report 30/06/91). This impeded start-up and imposed revenue restrictions.

Other factors impacting on the result were the economic recession in Australia which meant bearish demand for discretionary/leisure travel. The Gulf War affected tourism and increased fuel prices. There is no doubt that deep discounting stimulated passenger demand. The average real fares fell by 10% between September 1990 and June 1991. Figure 10 shows

domestic airline revenue passenger kilometres since deregulation. Figure 11 shows the increase in passenger numbers for each airline.

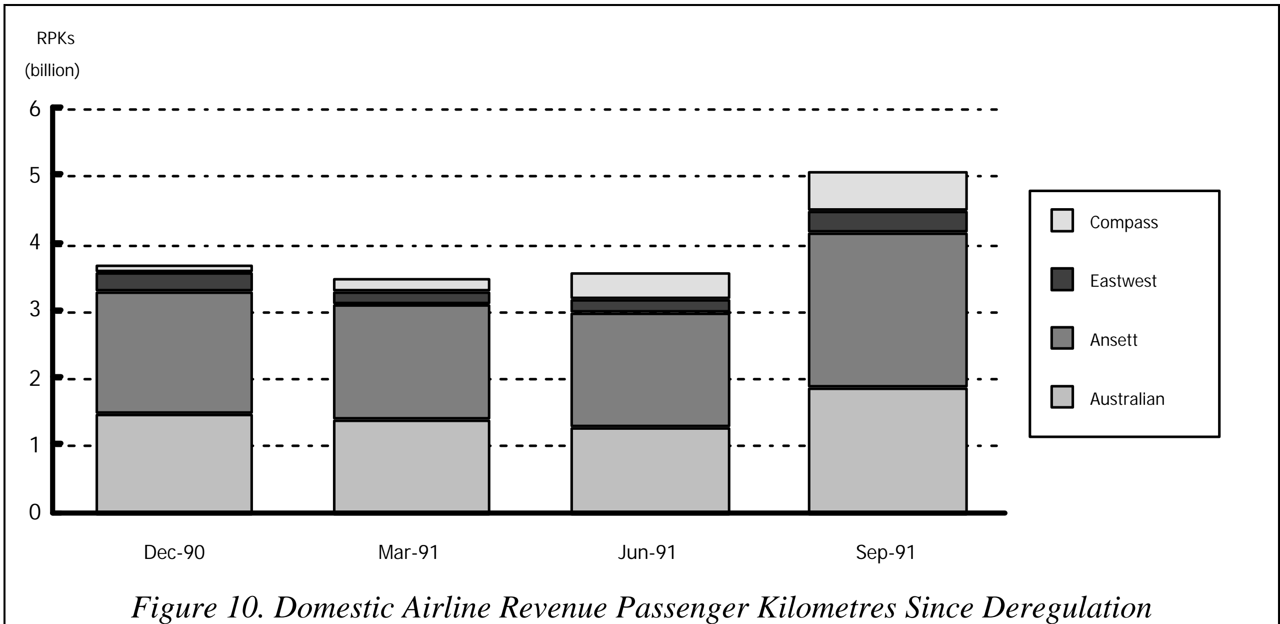



*Figure 10. Domestic Airline Revenue Passenger Kilometres Since Deregulation*

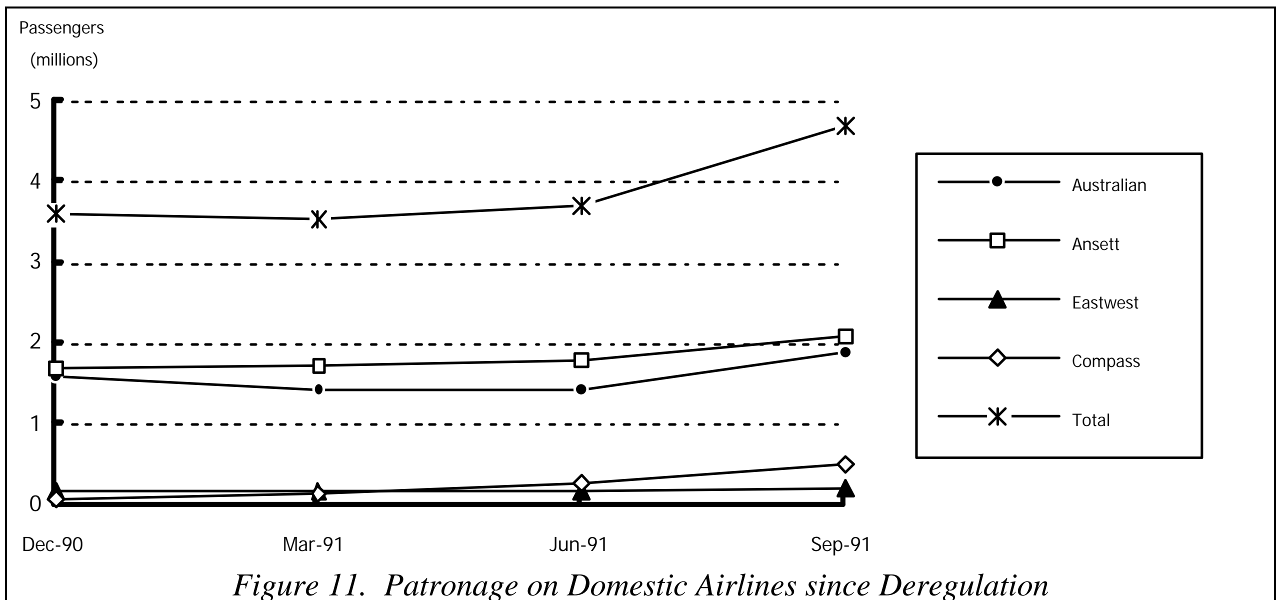



*Figure 11. Patronage on Domestic Airlines since Deregulation*

# 5. WHAT WENT WRONG?

When on 2 April 1991, C. Bryan Grey in a typically confident and brave-faced style proclaimed:

> "We've come through a lot of difficulties and they have been resolved successfully. As of today, we've no more excuses for any problems we might face in the future";
>
> (The Australian, 11-12 January, 1992)

the shareholders' fears were allayed even though Compass had lost $2.7 million since startup. A few months before Compass collapsed, its Chief Executive remained optimistic in saying:

> "There has never, ever been any doubt we'll survive."
>
> (The Australian, 11-12 January, 1992)

The collapse of Compass came as a surprise to many especially since its deep seated problems had not been made public until this stage and, in the ensuing debate, widely divergent explanations of the Compass' collapse emerged. The Provisional Liquidator's view was that Compass failed to appreciate the likely cost of start-up, the likely lack of coordination of resources and facilities for a new business, and the response of its competitors, concluding that:

> "Each of these events depleted the available cash resources so Compass was forced to become radical in its approach, thereby exacerbating the strain on profitability and ultimately its cash resources";
>
> (Ferrier, 1992, p.6).

To what extent was Compass responsible for its own downfall? The Compass management has laid the blame squarely on the government and the lack of terminal facilities for its malaise. However, a number of analysts have attributed lack of success to the Compass management itself. Considering all of the arguments, the collapse of Compass has been attributed to one or other combination of the following:

- the relatively (high) barriers to entry which increased start-up costs
- the lack of reasonable terminal access
- competitors' responses
- Compass' competitive strategy (in particular its pricing)
- the actions of the Compass management itself
- "Force maujeure events."

## (i) Barriers to Entry - Their Cost

It is not enough to claim that barriers to entry contributed to Compass' demise. Compass had entered the market and competed. High barriers to entry can deplete the resources of a new entrant and it is therefore important to assess the height of entry barriers for Compass, but it is also necessary to consider on-going operational barriers. In the case of Compass, it appears that the latter were more critical.

One approach to defining entry barriers is to estimate any costs faced by new entrants. However, a more satisfactory definition is to include only those costs faced by new entrants to the market which are not faced by incumbents, allowing them a "pricing umbrella" and "supernormal profits" (Hensher, 1991a).

### (a) Economic Barriers

Economic barriers (natural barriers) are those intrinsic to the technology at hand. In the airline industry, they would relate to equipment and capital requirements. The primary barrier is the existence of scale or scope economies. In Compass' case, it was able to reap benefits of (large) aircraft size but then faced the downside of such large equipment in a reduced ability to offer a frequent service. Compass was also not at a disadvantage in respect of density economies because it freely chose to enter only the densest routes.

### (b) Capital Requirements

Capital requirements can be a major barrier to entry in some industries but, in the airline industry, equipment can be leased in a mature market for second-hand aircraft, thus precluding large initial outlays. Perhaps the most important aspect of capital for a new entrant is working capital - what experts have called the "**fighting fund**". It would appear that this was a major factor in Compass' downfall. It was under capitalised and fought a losing battle against the majors who had greater resources.

Experts in the aviation industry posit that a new domestic airline of Compass' size needs at least $120 million clear of leasing and other commitments to underwrite its first year of operations (AFR 17/01/92). Bryan Grey's original estimate was $100 million which he cut back to $85 million after a capital raising proposal to investors through ANZ McCaughan failed. He finally went to Potter Warburg who agreed to underwrite a public float of $50 million which, in the event, was rushed and was over-subscribed. Compass eventually obtained a $15 million premium, but this proved to be insufficient.

The risky nature of domestic aviation deters investors; the industry's betas are quite volatile and returns have not been flattering in many countries that underwent deregulation such as the USA. A number of financial experts were sceptical of Compass' ability to raise the requisite finance from the public. Roger Sharp of Ord Minnet for example, felt that there was a serious shortage of capital in Australia in 1990 and Compass would not be able to raise the "required" capital without discounting the share price (Sharp 1990). Institutional investors were also reluctant to invest in the new venture when first approached for placement. Most of the scepticism stemmed from the economic uncertainty caused by the pilots dispute, infrastructure constraints and problems, uncertainty about deregulation, the possibility of a single aviation market under CER, and fluctuations in oil prices.

It is notable that 40% of investment analysts downgraded their airline profit forecasts at the end of March 1990, a repetition of concerns over the oil price and the perceptions of an economic slow down. Ord Minnet had been successful in floating NZ $168 million shares in Air New Zealand in 1989, but in the Compass case it was noted that:

> "The proposed start-up does not face a favourable capital raising environment. They should be very cautious about listing on the Stock Exchange until their cashflows are positive and running smoothly."
>
> (Sharp, 1990)

At the time Compass entered the industry, there were few willing investors and it thus revised its requirements sharply downwards. It must be said that this action increased the risk associated with the start-up venture and experience now shows that this under-capitalisation made Compass always desperate for cash and led it to take actions which a more liquid ventures would not have needed to contemplate.

### (c) Firm Created Barriers to Entry - Their Cost to Compass

As noted previously, the majors repositioned themselves and raised the barriers to entry for incumbents with strategies of vertical and horizontal integration. The majors bought a number of travel agencies and firms providing complementary products, and they both joined the Galileo CRS, formed strategic alliances with car hire firms, hotels and other travel related suppliers. Perhaps the most costly barrier as far as Compass was concerned was that of the terminal leases the incumbents negotiated with the Federal Government. Since Compass has blamed the lack of proper terminal access for its downfall, this matter will be considered in greater detail below.

Frequent flyer programmes were used by large incumbent airlines after deregulation in the USA to fight the competition from new entrants lacking extensive networks and administrative resources to offer such benefits to loyal customers. The frequent flyer programmes can therefore act as a barrier to entry and operation and it is notable that Australian and Ansett introduced frequent flyer programmes into Australia after deregulation. Compass responded by offering two free tickets with every Compass Class purchase to the same destination, a costly alternative to the airline. **Product differentiation** relating to brand identification, customer loyalty and goodwill becomes a barrier when an entrant has to commit **expenditure to dismantle the loyalty achieved** by incumbents. In Compass' case, this expenditure included image building advertising, special introductory travel packages and heavy discounting on some new routes such as Sydney-Perth. Although these might be regarded as **the normal costs of doing business**, they depleted Compass' meagre cash resources. In sum, there appear to have been some barriers to entry in the deregulated domestic aviation industry, but they were not insurmountable excepting the issue of the terminal access.

## (ii) Compass' Competitive Strategy and Competitor Reaction

### (a) Cost Leadership Strategy

In an interview on the eve of deregulation, the Chairman of Compass revealed a "cost leadership" strategy (see Porter 1980). Bryan Grey is quoted as saying:

> "We are proposing that our Melbourne-Perth, Sydney-Perth and Melbourne-Cairns fares will be a basic 50% of the Ansett/Australian fare. Thus all our daylight services fares are 80% of the [incumbents] economy fares and our curfew fares will be 50% of the Ansett and Australian economy fares",
>
> (Grey, 1990a, p.22).

This was a strategy to undercut the majors on three major segments o<u>n a time of the day basis.</u> He went further to justify the choice of the cost leadership strategy:

> "Our breakeven load factor is much lower than theirs and we therefore can discount down below their levels and still be profitable."
>
> (Grey, 1990a, p.22).

Brian Grey made a **grand** and perhaps **disastrous assumption** when he said:

> "But I believe that you have to look at it from a pragmatic point of view - they are not going to want to make losses any more than we would want to."

(Grey, 1990a, p.22).

The choice of the cost leadership strategy was a reasonable one by many standards, given Bryan Grey's observation in May 1990 that:

> "Had the domestic operators controlled costs more efficiently over the past 45 years and if their level of airfares were not at a point which discouraged people from flying, there would be no room for start-ups."

(Grey, 1990, p.22).

The high operating costs of the majors were the main motivation for Compass' entry. Kirby (1987) examined the cost structures of the majors. He asserted that the two airlines, under no pressure from outside competition, had established a "quiet life" duopoly. The industry degenerated into one lacking in innovation, market development, and offering consumers little choice of services and prices reflecting bloated costs. Kirby used an econometric model of airline total operating costs which took into account the multiproduct nature of airline services and found that Australian's operating costs were 5% higher than that of Ansett and Australian's costs were 55% higher than its US counterparts. Kirby attributed this to an inadequate fleet selection policy, overstaffing and the ability of the airline to pass on inefficiency costs to the consumer. There was therefore room for new entrants to compete on price. But the assumption that Compass made was that the incumbents were not capable of cutting costs to "reasonable" levels.

In terms of a generic competitive strategy, Compass had a strong profit incentive to pursue the cost leadership strategy. An airline's cost position is determined by such policy issues as aircraft type, fleet size and configuration route selection, frequency of service, stage length of passenger haul, sales and promotion activity, wage levels, quality of meals, which airports are used, the level of amenities at the terminals, baggage allowance offered etc. A "no frills" airline can reduce costs by opting for no meals or charging for in-flight services, no free baggage allowance using spartan terminals and onboard ticketing. Two types of passengers can be targeted, business or non-business, and the emphasis on these sub-markets can have a significant bearing on costs. Bryan Grey did not want Compass to carry the tag of a "no frills" airline. In a news release dated 19 December 1990 he stated:

> "In our view, the overall standard of service and passenger comfort is better than Ansett or Australian Business Class",

(Sydney Morning Herald, 19 December 1990).

Such a statement would suggest that although Compass' strategy was originally to be that of cost leadership, it lost focus and thus became what Porter (1980) described as "stuck-in-the-middle".

**An inevitable consequence** of the cost leadership strategy is **price competition**. All the efforts to reduce costs such as care in fleet selection, staffing policies, route selection, and well planned frequencies and schedules, should give the firm a competitive advantage. Lower costs mean that the firm can afford to undercut its competition on fares, but this may be only sustainable in the short run. The majors were given the benefit of three years before Compass' entry to rationalise their operations. Even so, Compass costs were lower than that of the majors and it was a cost leader. However, this **leadership needs to be transformed into profits through sensible pricing policies**. Compass' discounting proved to be too deep and in the end its advantage was dissipated. Ted Harris, the Australian Airlines Chairman commented:

> "The reason for the collapse was that Compass sold its airline tickets at prices so heavily discounted that the company ceased to be able to meet its financial obligations. What we had was a Myer Sale which should have lasted one week [but] lasted 12 months."

(Sydney Morning Herald, 5/01/92).

It would appear that Compass' choice of the cost leadership strategy was well thought-out in its operational decisions evidenced by its fleet selection, scheduling crew rostering etc. But the advantages gained from its low cost operation were dissipated through "**imprudent pricing**".

## (b) Pricing Strategies

Compass' basic pricing strategy was to undercut the majors achieved through discounting. What went wrong with its pricing was the level of discounts and, in some cases, their timing. Discounted fares were initially intended to fill up Compass' planes, but when the company achieved load factors that were well above its target of 60% it continued to initiate discount, leading to a suspicion that some discounts were necessitated by the company's dire need for cash.

A longitudinal analysis of the discount war (see Appendix A) shows that Compass initiated a number of the discounts, and where it had not, it responded with even deeper discounts

compared to what the majors had put up. Signs of Compass ' desperate need for cash were reflected in its pricing policies especially after August. Stockbroker ANZ McCaughan's Mr Dyson in an October 1991 report in the airline industry stated:

> "The objective of Compass' bulk ticket sales campaign appears to be to bolster cashflow in the short-term, which would seem to indicate a tight funding position on an under-capitalised balance sheet."

(Sydney Morning Herald, 7/01/92).

This was more akin to a market harvesting strategy especially evident in the way Compass cannibalised its business traveller market by offering very deep discounts to bring in cash in the short term. Mr Grey personally admitted that Compass could breakeven on an $85 Melbourne-Sydney one-way fare only if it achieved 80% - 90% load factors, yet Compass cut the fare to $100 return.

A comparison of Compass' pricing strategies and that of the majors reveals that while the majors matched Compass fares at the low end of the market, they did not discount to all their customers; their discounting was selective. The graph below illustrates that Compass' yield deteriorated rapidly from February onwards, yet Australian's yield was on a slow downward trend because of the depth of the discounts in mid-year.

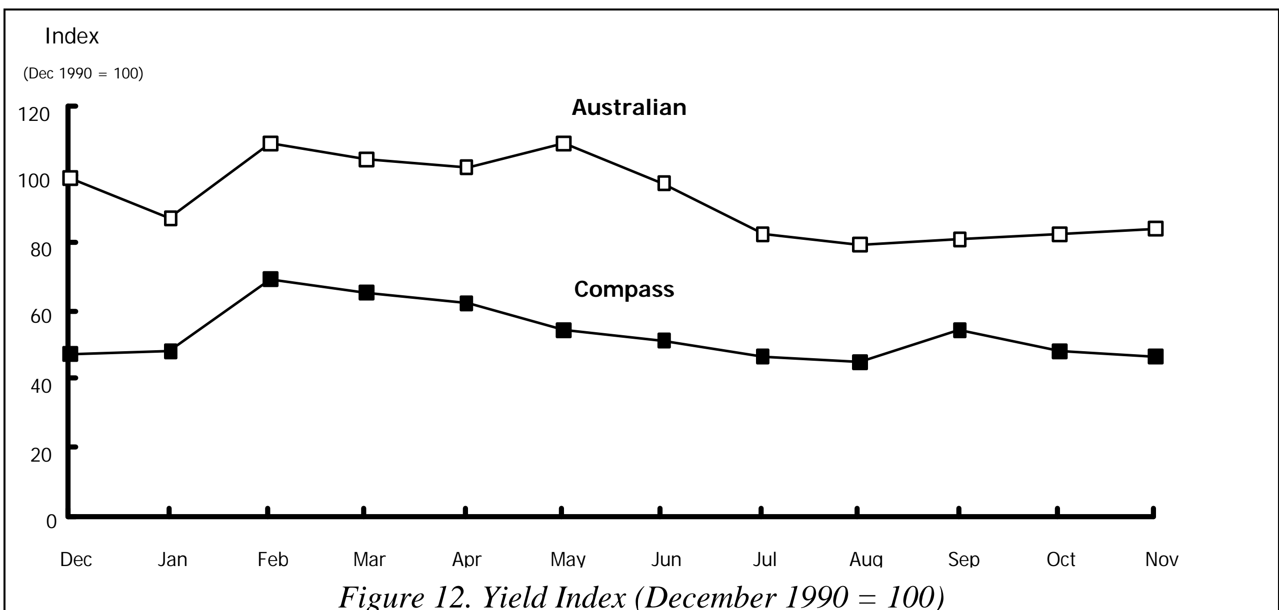



*Figure 12. Yield Index (December 1990 = 100)*

## (c) Yield Management

Questions have been raised as to whether Compass subscribed to the idea of and actually practiced yield management techniques, the objective of which is to maximise profits for a given flight rather than to maximise cashflow (Kraft et al, 1984). The fact that almost every major North American airline adopted some system of managing seats, indicates that yield management is crucial to profitability (Kraft et al, 1984). Yield management predicts, using the likely load and fare mix of each flight, the flight profitability and ensures the right ratio of differently priced seats are offered to the market. The concept rests on four characteristics of airline markets: perishability of the product (seats), the ability to price discriminate, the joint production of seats in various fare classes, and the predictability of demand.

The majors have developed their use of yield management programmes, and Compass, before it commenced operations, claimed that it would adopt the technique. With much of the travel agency industry linked to CRS's the majors had a head start in applying information technology and they used their position to lock-in their direct corporate business and controlled agencies and the distribution of fare types. In retrospect, it would appear that there was no serious commitment in Compass to practice yield management; this was revealed in a speech to the Australian Transport Research Forum in Hobart in 1991, Mr Bryan Grey said:

> "We don't believe in sophisticated systems such as yield management, we keep things simple and operate on a day to day basis."
>
> (Grey, 1991).

It would therefore appear that even if there were "grand" plans for a yield management system, it was cast aside as Compass grappled with the more immediate problems of technical insolvency. The very fact that Compass discounted so deeply to business passengers, offering them undated, unlimited coupon tickets, is a pointer to the lack of a proper use of yield management techniques. Compass was discounting to the very premium fare passengers it strove so hard to attract. Besides, Compass' discounts often overlapped and, where it reacted to discounts initiated by the majors, its own discounts apparently disregarded what it might have earlier planned - a pointer to the lack of proper yield management practices. Despite Compass' protestations to the contrary, it has turned out that Compass did not have an on-line yield management system in place in its crucial start-up phase and it appears that such a system was to be acquired in 1992.

## (d) Market Positioning, Segmentation and Targeting

A Compass brochure to business travellers stated:

> "The Compass philosophy is to offer unconditionally lower fares on every seat, every flight, every time."
>
> (Save Money on Your Business Travel).

This philosophy might be taken to be a commentary on Compass' marketing philosophy. What was not clear though was whether Compass wanted to be a "no-frills" airline or to be on the top end of the market. Its action (i.e. pricing) was more akin to the former, but its statements were aimed at pitching the company at the top end of the market. There was no clarity as to what Compass wanted to be in - the business traveller's perceptual map and the non-business travellers' mind. It is as though it wanted to be everything to everyone - "stuck-in-the-middle" (Porter, 1980).

Compass had 8.9% of the business travel market in the last quarter of 1991 (BTCE, 1991) but this share had been lured by heavy discounts and was not a high yield market. Compass seriously considered how it might increase its average yield from the business travellers late into its operations, belatedly introducing a business class section on its aircraft in December of 1991. From its inception, Compass embraced the strategy of being a single class carrier despite the failure of similar single class carriers in the USA such as People's Express.

Market research can also be valuable in positioning the firm and in targeting major segments to match the company's offers, yet Bryan Grey, in an interview in October 1990 said:

> "I don't believe in market research, as much as other people do. I think it is important, but don't believe it until it is achieved."
>
> (Grey, 1990a, p23).

Compass commenced a major business venture without in-depth research into its market, designed its service in the absence of specific information about consumer wants and embarked on deep discounting without any evidence regarding the impacts of low fares. The lack of proper targeting is also evidenced by Compass' failure to bid for freight early into its operations. It began to capitalise on the unique ability of its Airbus fleet to carry big consignments of outsize freight late in the year. When the airline collapsed, it had uplifted about 1000 tonnes of freight for carriers such as Qantas, Continental, United and Northwest, but this represented only 20% of its capacity (Australian Financial Review, 2/01/92).

## (iii) Competitors' Response

A costly assumption that Compass made was that the majors would not respond to its discounts in the way they did and consequently underestimated the degree of the ensuing price war. When the majors responded by discounting to the same level of fares as Compass, Mr Grey accused them of predation, and after its collapse claimed that:

> "... the financial problems at Compass emanated from the predatory pricing policies of Ansett and Australian."
>
> (Sunday Telegraph 22/12/91).

Further, he argued that Ansett and Australia had invested

> "millions and millions of dollars in the discount air fares pricing war undercutting Compass to force it out of business"
>
> (Sunday Telegraph 22/12/91, p.4).

Both of the major incurred losses for the year, but they were better capitalised than Compass and were able to sustain the fares war. The Trade Practices Commission is investigating the issue of predation by the majors.

## (iv) The Compass Management

A notable feature of most executive service contracts is the heavy amount of responsibility they bear for the performance of the company and ultimately, responsibility lies with the company's directors/executives. Bryan Grey gave the impression of being a hands-on manager and it is worthwhile to examine to what degree he and his executives were responsible for the collapse of the company.

### (a) A Risk Prone Management - "Reckless" Discounting?

The Compass management took risky decisions on a number of occasions exemplified in their price discounting strategies and the ultimate admission by Mr Grey that:

> "I didn't believe that they were willing to lock us into those prices and to lose hundreds of millions of dollars themselves to hold our head under water at those prices."
>
> (Grey, 1991a).

With his experience in the aviation industry, Mr Grey and his executives might have expected this outcome especially given the ample evidence from the US experience of deregulation that the big airlines were prepared to fight it out for market share and to make heavy investment in the hub-and-spoke systems to consolidate their market shares. In the context, the forecasts that Compass made of profitability have proven to be too optimistic. The accounting concept of conservatism seems to have been disregarded by the Compass management in making its forecasts. Indeed, its Chief Executive in his capacity of manager of Air Niugini was accused by the PNG's Omsbudsman Report of a similar shortcomings in saying that:

> "Based upon a flimsy foundation of unsupported assumptions and over-eager optimism, the expansion of routes and the acquisition of additional aircraft was both ill-conceived and ill-timed."
>
> (Sunday Telegraph 22/12/91, p.4).

**Timing** was important in Compass' case. When it entered the industry, not all the ground work had been done and negotiations were still going on for terminal access with Australian. Despite this, Compass decided to take **forward bookings** for commencing services in December as early as October 1990, prompting one of Compass' former executives to comment that they were operating as though a gun was held to their heads. Knowing that there were no prospects in the then near future of new entrants (most were still negotiating for their Air Services Certificates), the Compass management could have delayed take-off until all negotiations for terminal access were finalised. The company was required to pay Australian a security deposit at short notice for using the terminals before negotiations were finalised, a drain on its meagre cash resources.

The company was **under-capitalised from day one**, and, proceeding with substantially less than the $100 million first believed necessary, Compass increased its risk. A Porter Marburg former partner is quoted as having said that the float was "fairly rushed" and that Mr Grey is an impetuous person (Business Review Weekly, 17/01/92). Knowing of its poor capitalisation and subsequent lack of cash, management should have moved early enough to correct the under-capitalisation problem, possibly by raising new equity. Instead, it gambled on "borrowing from passengers" as much of its discounting appears to have been motivated by the need for cash rather than market share build-up. In May for example, (Recession Buster) Compass decided to forward-sell heavily discounted seats to bolster liquidity. Alex Klujin, a former Compass vice-president of marketing was aware of good practice, but this was not implemented:

> "Its your mixture of fares that is important to profitability not your low-yield promotional fares or your high-yield business fares",

(Business Review Weekly 17/01/92, p.17).

By offering open-dated bulk tickets or freedom fares to corporate customers in June 1991 Compass was effectively discounting to the market that it hoped would provide its most important profits. For instance the Sydney-Melbourne one-way ticket was sold to business travellers at $95 and Compass only secured corporate business on the Sydney-Melbourne route at a more attractive rate of $165 (one way) in the last weeks of the airline - too late!

The company's discounted fares tended to **overlap** as one type of discount offer would come in whilst the other was still active. It became clear that Compass would still have operated at losses well into 1992 and financial analysts commented that it was no surprise that the company collapsed around Christmas time (see The Business Review Weekly, January 1992). In the previous months, a substantial amount of flight capacity had been sold to passengers at heavily discounted fares and few passengers booked for 1992. After the peak selling period just before Christmas, there were not sufficient buyers to sustain the cashflow.

### (b) Financial/Cash Management

Compass' liquidity problems existed from the beginning. Liquidity ratios either in the form of quick acid ratios or current asset to liabilities ratios may help to illustrate the point being made (Figure 13).

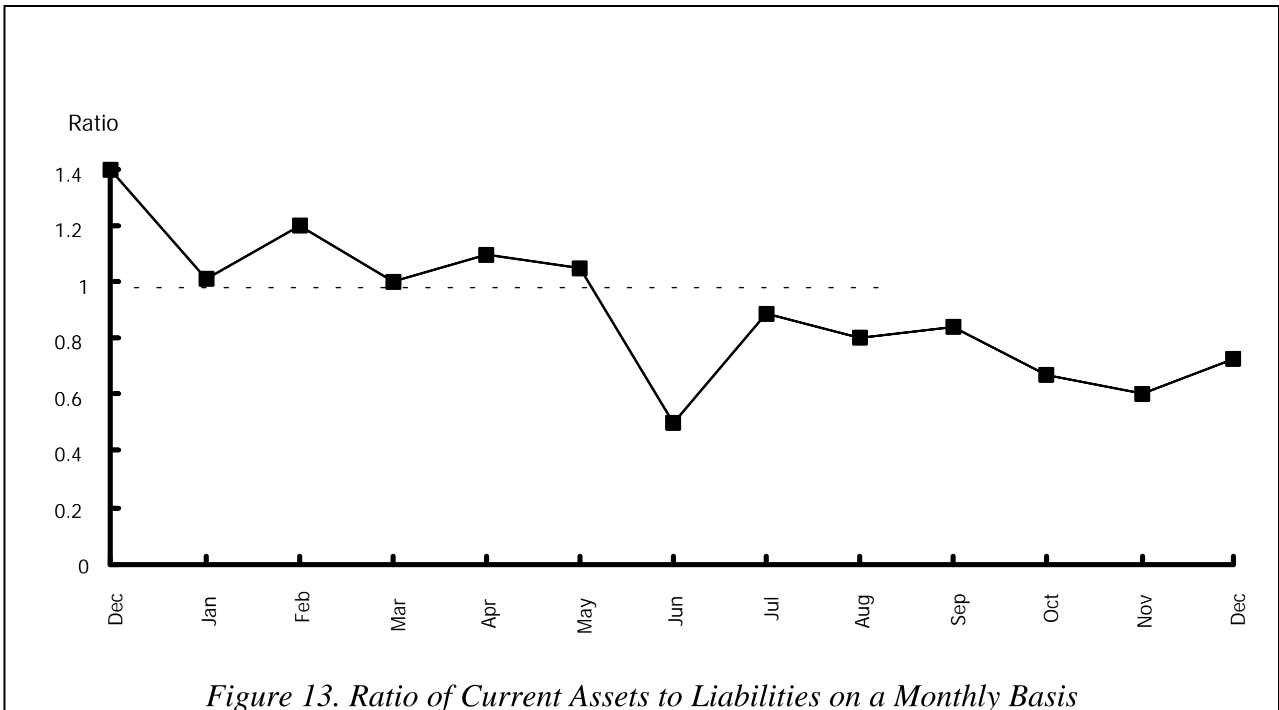



*Figure 13. Ratio of Current Assets to Liabilities on a Monthly Basis*

Pre-sold tickets increased as from May and Compass became more exposed as far as this aspect of unsecured creditors risk was concerned. It is significant that despite making a "profit" in June, this was the month when its liquidity ratios were at their worst. As from June onwards, Compass experienced problems in meeting its payments to Qantas, CAA, FAC and the aircraft lessors, and was slow in reimbursing passengers. The Provisional Liquidators proposal to get Compass back on the air without its current management reflected a lack of faith in the management of Compass.

## (v) "Force Maujeure Events"

There were events that were beyond the control of the Compass management which contributed to its problems and subsequent collapse. The late delivery of its third and fourth aircraft was one such event. Compass' third and fourth aircraft were planned for delivery and commencement of service in February and March 1991, respectively. The third aircraft was delayed due to industrial action at the manufacturer Airbus Industrie, finally delivered in July 1991.

The fourth aircraft was significantly delayed due to an accident at the manufacturers facilities, requiring major repairs. The aircraft was eventually accepted for delivery in late August 1991 and commenced operations in the last week of August. The combined aircraft delays reduced Compass' available capacity by approximately 26% from that planned to the 30th of

June (Jeffrey, 1992). To cover for the delay in the third aircraft over the Easter period, for which significant bookings had been taken, Compass took a short term lease of an Airbus A310 aircraft from Air Niugini at a significant penalty compared to long term arrangements.

As part of a settlement arising from the delay, Airbus made available spare parts worth about $20 million but denied liability. Some of this $20 million involved credit for parts for which Compass had already received or were on order and this worsened the cashflow position. Due to this continuing delay of the fourth aircraft, Compass introduced an additional aircraft, an Airbus A310-300, on lease from Canadian Airlines and commencing services on the 1st of July to be retained on a three year operating lease. All these delays had a significant impact on scheduling, load factor, and hence yield. They also reduced **schedule flexibility** and **frequency attributes** that are **valued by the business traveller.**

Compass came into the market at a time when demand for leased aircraft was bullish. The operating leases it struck with Polaris and Monarch Airlines were at punitive rates; 1990 was the peak of an ordering binge. But after 1990, lessors managed to place only 22% of the 850 aircraft they had committed to buy. For instance Triple A, another potential entrant, claims that its aircraft cost one tenth of the $800,000 a month Compass paid for its two A300s (Age 15/09/92).

Technical problems associated with aircraft maintenance requirements forced Compass to buy a General Electric engine, thus tying a sizeable amount of the airlines start-up capital in aircraft spares. The Gulf War affected fuel prices and thus added unbudgetted fuel costs at the same time that demand for discretionary and tourist travel was depressed. Some analysts would argue that all airlines were affected the same way by the recession and the fuel price hikes, but these twin effects would have been much more poignant for Compass given the cash-strapped nature of its operations.

Compass drastically underestimated the need for an **adequate reservations system**. There was an inability to answer all calls promptly with a subsequent loss of customers, leading Barry Cooney (vice president of customer services) to comment that:

> "The net effect is that it destroyed our credibility in answering telephone calls."
>
> (Business Review Weekly, 17/01/92).

It took Compass until September 1991 to set up a telephone reservation system that was at best satisfactory.

## (vi) Predatory Pricing

Soon after the collapse of the Company, Bryan Grey accused the majors of predatory pricing. Predatory pricing is the practice of charging a very low price for a product/service with the intent of driving a competitor out of business, with a subsequent raising of prices after the entrant has failed to survive. Predatory pricing is illegal under the Trade Practices Act, but proving its presence has always been difficult and expensive because it must be shown that the predator explicitly attempted to destroy a competitor and the predatory price was below the defendant's average cost.

The Trade Practices Commission is investigating Compass' claims of predation. It is a daunting task complicated by the following issues:

- Compass' assertions do not relate to any particular airline. They have been blandly heaped on both Ansett and Australian. This presupposes **collusion** between Ansett and Australian in fare setting - an argument that is difficult to sustain given evidence of competition between the two.
- Average costs, and therefore the base price, in the airline industry are hard to arrive at. As one unnamed sceptic commented:

> "Airline accounts can read almost anything the airline wants them to read."
>
> (Sydney Morning Herald, 12/05/90)

- Compass initiated a number of fare discounts with some fares set below breakeven point. Bryan Grey admitted that Compass had to charge at least $85 one-way on the Sydney-Melbourne route in order to break-even on a load factor of 80-90%. Yet in November 1991 Compass set the fare at $100 return - well below the break-even point and at a lower than 80% load factor. The question then arises of who was the predator?
- After Compass ceased operations, the majors still continued (albeit in the short term) to offer deep discounts, making it harder to legally prove the charge of predation.

Whatever conclusions are reached after ex post investigation and rationalisation by the TPC and interested commentators on whether there was predatory pricing or not, there will

always be a cloud of doubt as to whether the said practice was responsible for Compass' demise. The Chairman of Australian Airlines reacted to Compass' charges:

> "False allegations of predatory pricing policies and of conspiracy which have been made by Compass can only be assumed to be an attempt to obscure and distort the reasons for the Compass collapse."
>
> (Australian Tourism Development Magazine, 1992, p.15).

## (vii) Terminal Facilities

The most controversial issue as far as the Compass collapse is concerned is that of terminal facilities. Bryan Grey has claimed that 90-95% of the company's collapse was due to lack of proper access. There is some truth in the view that terminal access affected Compass' operations adversely, but the BTCE (1991a) asserts that since Compass was able to compete, terminal access was not an absolute barrier to entry. We now examine the issue in more detail.

# 6. A MAJOR ISSUE - TERMINAL FACILITIES!

Denial of access serves as an absolute barrier to entry. If access is given but restricted and not of the standard required to run an airline efficiently, then this is a barrier to operations. The "grandfather rights" to terminal facilities and development land around them in the form of 20 year leases and eight year leases (for land) were negotiated by the Federal Government and the incumbents on the eve of the formation of the Federal Airport Corporation. Mr Grey has described them as "**scandalous**" and the FAC and the TPC have taken issue with the way terminal access has been handled, including the way the terminal leases were concluded.

In 1990, 23 million passengers passed through the top ten airports representing 90% of all passenger movements in Australia. Table 5 shows the Domestic Passenger Movements at Major Airports. Over 63% of all passengers passed through Sydney, Melbourne or Brisbane and Compass was operating on those routes (BTCE, 1991a). Any restriction or access to terminals at these airports raises serious questions about competition policy.

**Table 5. Domestic Passenger Movements at Major Airports**

| **Airport** | **Passenger Movements** | **Percentage of** |
|---|---|---|
| **(000s)** | **all Movements** | |
| Sydney | 6 690 | 27.0 |
| Melbourne | 5 904 | 22.8 |
| Brisbane | 3 486 | 13.4 |
| Adelaide | 1 864 | 7.2 |
| Perth | 1 399 | 5.4 |
| Canberra | 949 | 3.7 |
| Coolangatta | 892 | 3.4 |
| Cairns | 703 | 2.7 |
| Hobart | 535 | 2.1 |
| Alice Springs | 447 | 1.7 |
| Top Ten Airports | 23 171 | 89.4 |
| **Total Australia** | **25 930** | **100.0** |

Source: BTCE (1991a) from DOTC (1990).

In December 1987 just before the handover of airport management to the FAC the Federal Government renegotiated the lease arrangements with Australian and Ansett for terminal facilities at Sydney, Melbourne, Perth, Adelaide, Launceston and Coolangatta airports. The

new lease conditions for Sydney airport not only cover the existing terminals, but also expansion land. The arrangements gave the incumbents leases with options for around 28 years for all terminal space and land for terminal development. The FAC would provide accommodation at Brisbane and Hobart, whilst the leases required Australian and Ansett to provide gates at their terminals as follows:

| | |
|---|---|
| Sydney | 2 each |
| Melbourne | 2 each |
| Adelaide | 1 each |
| Perth | 1 each |
| Coolangatta | 1 by Ansett only |

## (i) Compass' Problems with the Leases

From the time the leases were signed, Mr Grey constantly criticised them. He claimed that the turnaround of an aircraft particularly a domestic jet aircraft requires approximately 45 minutes requiring the minimum time available at a stop of one hour to allow for pushouts. With aircraft movements limited at the curfew ports to approximately 7am to 7pm, it follows that only twelve positions are available at each slot, which means a limitation of 24 movements for Compass at both Sydney and Melbourne, the two busiest ports. But even this was subject to traffic capacity and flight scheduling (which tends to be clustered) thus further limiting access. Grey Claimed:

> "For such a time that common user terminals are not available it is impossible to operate eight or twelve units as other start-ups projected."
>
> (Grey, 1990)

Given these restrictions, Grey argued that the sensible operational decision was to select high capacity aircraft to maximise throughput at the terminals, a strategy enhanced by the lower operating cost (on a per seat-kilometre basis) of these aircrafts. Interestingly, Compass first sought Boeing 767's and wanted Qantas to maintain the planes, but when the proposed deal fell through, the preference for B-767's declined.

## (ii) Rents and the Conduct of the Sub-Lessor (Australian)

Compass approached Australian for sub-leases at Sydney, Melbourne, Adelaide and Perth. It is reported that Australian was co-operative in negotiations before Compass started its flights, but all this changed as Mr Grey had anticipated:

> "I don't want to overstate the degree of co-operation from Australian. At the moment everyone is being very nice. It's the velvet glove. But in a minute, that attitude could change."
>
> (BWR, 17/01/92)

Compass and Australian are presently in court over the rent charged and the quality of access afforded Compass. Compass claimed that Australian overcharged it on rentals at Melbourne and Sydney airports. This dispute was settled by arbitration. Compass was awarded $4.9 million, although this has been challenged by Australian Airlines, and taken to the high court.

**(a) Melbourne Airport**

Compass' complaints with its access at the Melbourne terminal were that its passengers were provided with inadequate information (lack of signs), that they faced long walking distances to the most remote gates and that baggage handling arrangements were inefficient. The last-mentioned factor was claimed to add to costs and difficulties manifested themselves in lost baggage and delays. In total, compass claimed that it had lost between $20-30 million because of inadequate access to this terminal. When taken to arbitration, a decision was handed down for Australian Airlines to compensate Compass for damages of $4 million, although this is subject to appeals.

Compass' claims will be dealt with in the courts, but research evidence to support its arguments are weak. Several recent studies (see Lemer 1992, Seneviratne and Martel 1991) have found that passengers do rate information, walking distance and baggage handling highly in their assessment of terminal performance. However, the issue is complicated because frequent flyers tend to arrive late for their flights with a desire to be seated in a departure lounge as quickly as possible. Leisure travellers arrive early and tend to seek provision of service inside the terminal. Thus, attitudes about terminal performance depend very much on the mix of traffic being served. More importantly, it is necessary to ask the question whether the traveller's perception of the terminal reflects itself within the traveller's preference for a particular carrier. Few published studies of carrier choice exist, but there is some limited evidence that passengers rate terminal performance low relative to other determinants of carrier choice (see Etherington and Van 1984). It is more likely that terminal performance would be limited to an airline where that airline appears to be in total control of the terminal, but airlines are more likely to want to minimise their terminal costs when such an association is weak (Lemer 1992).

**(b) Perth Airport**

At Perth airport, Australian had wanted Compass to alter its timetable to accommodate passengers in its terminal area. Unwilling to upset its aircraft schedule, Compass chose instead to use the international terminal. This was disadvantageous because domestic and international terminals at Perth are one kilometre apart.

**(c) Sydney Airport**

At Sydney Airport Compass passengers had to carry baggage upstairs to check-in counters whereas the Australian ground level check-in counters were 20 metres from the street. The direction of the lone escalator near the Compass check-in counter was determined by whether most passengers were arriving at the terminal or departing. Passengers had to walk through a narrow passage into the holding lounge and, when two Compass aircraft were boarding simultaneously, only about half the passengers could be seated in the lounge. Business travellers disliked collecting their baggage at a regional airlines terminal.

**(d) Adelaide Airport - the Tin Sheds and Pin-Stripes**

At Adelaide Airport, when Compass commenced services in July 1991, negotiations with Australian for terminals were not complete. Compass had to use a tin shed as a make-shift gate, leading Compass to complain that it could not attract "pin-stripe traffic". There is no doubt that the terminal leases gave the incumbents a lot of market power, a direct parallel to experiences in the USA after deregulation.

In 1986, the US government greatly increased the competitive strength of incumbent carriers by giving to the carriers at no cost, their existing landing and takeoff slots to be traded as their own property. The value of landing and take-off slots to an airline can be gauged by Pan Am's purchase in 1986 of **three gates** at both Boston and New York and 64 landing slots in New York and Washington for $65 million (Button, 1989). As to what value and therefore how far Compass was disadvantaged will be determined by the courts as Compass and Australian are still involved in litigation and the Trade Practices Commission (TPC) has mooted the idea of the TPC taking up Compass' case. This brings us to the roles of the TPC, the Prices Surveillance Authority (PSA) and the Federal Airports Corporation (FAC).

## (iii) The Federal Airports Corporation

The Federal Airports Corporation's role and responsibilities are to provide, operate and maintain terminals, runway, taxiways and aprons, co-ordinate planning and development, provide services and facilities, and provide consultancy and management service. The signing of the terminal lease agreements with the incumbents just before the inception of the FAC on

1 January 1988 meant that the FAC's hands were tied. It has publicly criticised the agreements.

The FAC has endeavoured to provide terminal access for Compass at Brisbane and Cairns. It has also undertaken to help the intending new entrant, AAA, to set up its own gates and terminals, before it was known that AAA was just a "paper" company. There might be a case for the FAC to be given much more power to oversee how the majors extend sub-leases to new entrants.

## (iv) The Trade Practices Commission

The TPC undertook in 1990 to:

> "watch closely the process of negotiation that occurs in respect of levels of access and the provision of necessary facilities to new entrants."
>
> (Merlini, 1990, p.5)

The TPC's main role is that of an industry watchdog. Section 46 of the Trade Practices Act empowers it to take action against abuse of market power. To date it is investigating Compass' allegations of predatory pricing by the majors. Perhaps its most important role would be to ensure that all intending new entrants get a fairer deal in terms of terminal access and fair competition generally. Although it rarely takes companies to court for litigation, its philosophy is predicated on the assumption that the self-interest of business is staying in business and the very large investment in goodwill that a business would have made over the years may be seen as a guarantee that it will behave within the law.

## (v) The Prices Surveillance Authority

The PSA acts as a monitor rather than a strict controller of pricing policy. It has no direct power to order change in a pricing structure but has tremendous power through its ability to inform the market and make public its attitudes on pricing stability. In essence, the PSA's guidelines provide for cost based pricing with a general requirement that costs be actually incurred rather than simply anticipated. Its much acclaimed power has not been demonstrated in the aviation industry. There could be a case for it not only to look at price increases but also discounts that are prejudicial to the well-being of an enterprise, and hence its shareholders and creditors.

# 7. THE FUTURE AND NEW ENTRANTS

The collapse of Compass has precipitated an inquiry by the Federal Government into the operations and structure of the domestic aviation industry, with questions such as "was there ever a level playing field?" being asked. Although, barriers to entry and operation do exist in the form of restricted terminal access, the BTCE (1991) has argued that they are not insurmountable, even though they do impose a cost on the new entrants. From the individual air carrier's perspective, a lack of terminal access and ground facilities poses three serious problems; first, delays are costly because they entail unproductive use of aircraft and flight crew time; second, delays can impose additional indirect costs by delaying connecting flights to which detained aircraft and crews are assigned; and third, poor ground and terminal facilities used in passenger servicing and luggage handling can raise air carriers' operating expenses as well as introduce delays and disruptions of schedule operations.

Unlike air transport routes, where restrictions on entry are almost entirely artificial, constraints on access to airports usually reflect real physical limitations. In the Australian scene, the allocation of scarce terminal space has given the incumbents market power. A pro-competition policy would lessen market power of the majors by easing entry conditions through facilitating access to inputs.

The scope and effect of policy is greatest when it is directed forwards limiting the creation of market power rather than limiting its use. Industry watchdogs such as the TPC and PSA all have roles to play, but their roles tend to be reactive. Their attempts to limit market power abuse are made much more onerous by the fact that firms that abuse market power do so in subtle ways without really testing the law to its finite limits.

The Federal Government is well aware of the disadvantages that new entrants face because of terminal access constraints. It intends to spend $130 million on new airport terminal assets in order to avoid fledgling carriers being forced to operate from Ansett or Australian Airline's terminals (AFR, 10/02/92). These will be common-user terminals and plans are afoot to construct these at Sydney and Melbourne initially before going to other areas. These common-user terminals will be a big fillip to new entrants such as Transcontinental and Southern Cross, both having expressed reservations about using the majors' facilities.

The entry of Compass meant that domestic aviation travel became affordable to many Australians, an objective of the government when it introduced deregulation. The BTCE (1991a) undertook empirical research into the impact of discount fares across the top 100 markets and found that the presence of Compass has been a stimulus to competition while

Ansett and Australian were also competing more with each other than ever before. Domestic tourism was also stimulated and became the main growth industry during the recession. Also, increased competition forced the majors to cut costs.

The Compass collapse precipitated the government's wide review of aviation policy, both domestic and international. This has resulted in a "Sweeping three-pronged shakeout of aviation policy" (AFR 27/02/92). The main tenet of the reform programme is ultimately the creation of a single aviation market with New Zealand under the Closer Economic Relations (CER) umbrella. Stage one of the policy will mean the removal of equity barriers between Australian operators with the result that the privatisation process will be enhanced by clearing the way for Qantas to buy into Australian or Ansett and for domestic airlines to take a stake in Qantas.

Stage two will involve opening up the trans-Tasman services to any Australian or NZ airline, allowing domestic airlines to compete with international carriers on that route no later than 1993. Qantas will not be allowed to operate purely domestic sectors in its own right until multiple designation on international routes is extended to areas other than the Tasman. Stage three involves the implementation of a single aviation market with a common border which would allow all Australian and NZ airlines to operate within the two nations as well as trans-Tasman.

The option of merging of the Australian, New Zealand and trans-Tasman markets was examined by a Joint Australia-New Zealand study team consisting of the Bureau of Transport and Communications Economics and Jarden Morgan NZ Limited. The team found that:

- Any benefits to consumers from a relaxation of regulatory barriers to entry would come in the form of reduced airfares and an improvement in the quality of air services.

- Deregulation would create new opportunities for entrants, while subjecting the incumbents to the rigours of new competition.

- The net welfare gains from a single Australasian aviation market relative to Australian domestic aviation would be $53 million.

- If Air New Zealand were to respond to a possible Ansett competitive threat in the Australasian market by entering the Australian market, the welfare gain would be $141 million.

- Welfare gains would be less if there was to be restricted cabotage.

The study concluded that, overall, there are some net welfare gains to be had from a single aviation market under varied scenarios. Table 6 below summarises the welfare consequences of Australian domestic aviation, and a single Australasian aviation market.

**Table 6. The Welfare Consequences of Australian Deregulation and a Single Australasian Market**

| | Australian Deregulation | | Single Market | |
|---|---|---|---|---|
| | $M | | $M | |
| **Consumer Gain** | | 236 | | 329 |
| **Change in Airline Profits** | -48 | | -88 | |
| **Cost Cut Transfer** | | -71 | | -71 |
| **Net Welfare Gain** | | **117** | | **170** |

Source: (BTCE and NZ Study Team, 1991).

In the international distribution of the welfare gains Australia will stand to gain more. The achievement of the net benefits of a single aviation market might be constrained in the short term by the excess demand for runway access at Sydney's Kingsford-Smith Airport. Additional **terminal** capacity would be required if domestic airlines which entered the trans-Tasman market sought to use their existing domestic terminal facilities to process international passengers.

Questions may be asked whether Australia, with a population of 17 million can afford more than two or three airlines. Economies of scale, scope and density that have to be achieved limit the size or number of players that could participate fully and gainfully. Access Research (1989) has estimated that the Australian domestic market could only support three trunk route carriers. Where does this put the intending new entrants especially after the announcement that Qantas and Air New Zealand may compete domestically? Analysts tend to agree that there is no room for a third major domestic carrier and new entrants will have to concentrate on niches.

Notably, **Transcontinental** plans to position itself as an affordable, premium service, aimed squarely at the air-aware businessman. It plans to operate from Western Australia and

compete against Ansett WA using new aircraft. Initially it will lease six Boeing 737's from Peat Aviation and Braathen. The leases have already been negotiated but the chief executive is reported to be unhappy with terminal arrangements. He is reportedly quoted as saying:

> "We are starting from a very hostile environment."
>
> (Age 15/01/91).

Transcontinental intends to have one employee per seat compared to AAA's proposed one employee per 2.5 seats and Ansett's one employee per 5 to 6 seats; low overheads will translate to less sensitivity to load factor fluctuations (Age 15/01/92). Management projects that it will be profitable at a 50% load factor. It will eschew frequent flyer programmes. Transcontinental plans to have a large employee share ownership programme (ESOP). It has an investor who will provide 70% of the $160 - $170 million capital and 30% of the shares will be in a debt-financed workers' trust.

The collapse of Compass and the proposed single market has made it harder for new start-ups to raise capital. The cost of capital is a real barrier to entry. The Corporations Act provisions increasing director and stockbroker liability also suggest it might be a while before the stock market thaws. For instance, stockbrokers Porter Partners were obliged out of prudence and in a bid to parry away any possibilities of litigation in the light of a Compass collapse to spell out that

> "Compass must be regarded as speculative."
>
> (The Age 15/01/92).

AAA is proposing to start operating in June 1992 using DC-9-30's., originally to be leased from Ansett and of late to be leased from a Florida (US) based company. It plans to operate a "no-frills" shuttle service between Brisbane-Sydney-Melbourne. However, the airline has been recently depicted as a "paper company" and as of March 1992, did not have an Air Operator's Licence from the CAA, has no aircraft, no terminals, and is unable to pay its staff of 46. It has been accused of defrauding pilots, and the integrity of its managing director is being questioned (Sydney Morning Herald 12/02/92).

**Southern Cross aka Compass** now appears to be the most likely third player, operating under the Compass banner. The Provisional Liquidators have in principle agreed to its proposal involving the use of Compass' goodwill. There are however real danger signs for the market for start-ups and entrepreneurial capital in Australia. The nature of venture

capital projects like Southern Cross is such that the risk portfolio must be spread. Southern Cross plans to use MD-80 aircraft and will capitalise on the price elasticity in the market as demonstrated by Compass. The details of Southern Cross' takeover of Compass and using the Compass logo and livery will become clearer in the near future.

# 8. CONCLUSION

The broader question that arises from the commercial collapse of Compass is whether there is a case for ascribing its ill-fate to market failure (or more precisely the failure of deregulation) on the part of Compass' management. On the available evidence, it appears that Compass collapsed more because of its management decisions rather than the absence of a "level playing field". Poor capitalisation, poor risk management, poor pricing strategies, a poor service positioning strategy, all seem to have contributed to Compass' demise more than the much "trumpeted" limited terminal access. There is no denying that terminal access was unfavourable to Compass' operations, but to ascribe the failure of the company to it is unrealistic. Compass was able to compete and to get the load factor it had projected. It failed to price its services realistically.

The collapse of Compass has brought with it positive spin-offs in aviation policy formulation. The Federal Government is now considering building common user terminals to give new entrants a fair chance to compete. It is also proposing to create a single aviation market that will see Qantas, Air New Zealand, Ansett and Australian compete in the domestic aviation market. The industry is still in a state of flux and its future is not that clear. There are, however, some healthy signs as far as policy formulation is concerned while the government appears to be committed to letting market forces be the ultimate arbitor.

# *9. APPENDICES*

# Appendix A

## THE COMPASS CALENDAR -
## A CHRONOLOGY OF MAJOR EVENTS AND FARE INITIATIVES

Lead-up Deregulation
Raising the Barriers to Entry and Re-positioning by incumbents

August 1984: Pilots dispute seriously affects operations of Australian and Ansette
May 1987: Senator Evans announces end of TAP by 31 October 1990.
June 1987: Compass Airlines formed.
June 1990: Compass raises $65 million through public float.

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| Early 1990 | Australian<br>Ansett | 40% discount for travellers over 60 years to end 30 October 1990 | | |
| Late August 1990 | Ansett<br>Australian | 50% discounting for off-peak return travel - first on Sydney-Melbourne corridor and subsequently all the major cities | Sydney - Melbourne | a number of stay restrictions and booking restrictions |
| 6 September 1990 | Australian | 50% discount, minimum inflight service and add-on and back-of-the-clock flights. One flight on each route. | Sydney - Melbourne<br>Sydney - Gold Coast<br>Melbourne - Gold Coast<br>Melbourne - Cairns | 7 days advance booking required stay 7 to 14 days |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 9 September 1990 | Eastwest (a member of the Ansett Transport Group | 50% discount on its routes | Leisure market | 30 day advance purchase<br>3 nights minimum stay |
| 17 September 1990 | Ansett | 50% discount | Perth - Melbourne<br>Sydney - Perth | night flights from 1 October<br>no booking or stay conditions |
| 21 September 1990 | Australian | 53% discounts (average) | Major eastern cities | late night and overnight flights<br>duration 1 Novermber to 16 March 1991<br>7 days advance booking |
| 22 September 1990 | Ansett | 40% discount on Sydney - Melbourne return fare from 1 October for afternoon and evening flights - except Saturday afternoon | Sydney - Melbourne | both legs to be booked together<br>ticket purchase within 24 hours of booking |
| 1 October 1990 | **Compass** | Opened booking for 1 December take-off.<br>Discounts<br>i) 20% off Australian and Ansett economy fare across the board.<br>ii) 50% off the majors economy fares all transcontinental flights. | All routes | See particulars |
| 9 October 1990 | Australian | 1st 55% discount - response to Ansett and Compass night transcontinental flights increased to 55%. | | See particulars |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 17 October 1990 | Eastwest | 55% discounts on all flights booked by 31 October 1990 | All routes | For flight period 1/11/90 - 13/12/90 |
| 18 October 1990 | Ansett | 50% discount of off-peak services extended to Canberra.<br>60% discount "Rockbottom" on selected flights from 31 October to Brisbane. | Canberra<br>Other Eastern seaboard cities | 7 day advance purchase<br>no stayover provisions |
| **1 November 1990:** | **TAP COMES TO AN END** | | | |
| December 1990 | • 1st two weeks, low load factors. Flights cancelled.<br>• bookings for cargo received on Perth-Melbourne-Perth route.<br>• introduced night flights Sydney-Perth - 15 December.<br>• fare set at $250 "Day Take-Off". - Perth fare<br>• Compass **announces** that it's not taking the majors' **fare increase** of **7.5%** occasioned by **fuel hikes.** | | | |
| 18 December 1990 | **Terminals**<br>• Bryan Grey announces that Compass has no problems with Terminals at Brisbane and Perth.<br><br>• Reservation problems announced - reservation resource increased 3-fold.<br><br>• Bryan Grey - dismisses the "No Frills" tag and restates commitment "to being highly sensitive to demand patterns and having the flexibility and initiative to increase routes that people want to fly and **give them prices they can afford**". | | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| **ENTER COMPASS**<br>**December 1990: Compass begins operations with 2 airbuses, serving major cities on Eastern seaboard.**<br><br>**January 1991 Clearance Sale** | | | | |
| January 1991 | **Compass** | simply matches the majors' discounts | | |
| 1 January 1991 | Ansett | 61% discounts on > 150 routes between 15/01/91 and 3/02/91.<br>Sale period 2 - 14 January<br>2500 seats available daily | all major routes | one night stay<br>payment within 24 hours of booking and no refunds |
| 1 January 1991 | Australian | matched Ansett and extended travel period to 14/02/91 | | |
| 2 January 1991 | Ansett Express | same discounts as Australian | | |
| 3 January 1991 | **Compass** | 61% discount in advance<br>24 hours in advance standby<br>booking fare discount of up to 61% available 7/01/91 | all routes it serves | see particulars |
| 3 January 1991 | Eastwest | 50 - 60% discounts available immediately until February | | |
| February 1991 | . marked improvement in yield - at its highest.<br>. 3rd aircraft arrival delayed.<br>. no major fare initiatives. | | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| March 1991 | . no major fare initiatives.<br>. Compass hires Air Niugini Airbus to accomodate pre-booked Easter traffic. Punishing lease payments. | | | |
| April 1991 | . 4th aircraft delayed.<br>. Compass announces loss of $1.8 million for the half year ended 31/12/90.<br>. Bryan Grey announces on 2 April that Compass' problems are over and no more excuses were to be made should there be any problems. | | | |
| **THE 'MAY' RECESSION BUSTERS** | | | | |
| May 1991 | . the beginning of a major discount war.<br>. delays in aircraft delivery take their toll on yields. | | | |
| 3 May 1991 | **Compass** | 70% discounts on fares purchased by 31 May for **20 seats** on all flights for the **next twelve months** e.g. Sydney-Melbourne $85 one way. | all routes | fares transferable but not refundable |
| 9 May 1991 | Ansett Australian | responded but no limits to seats | all routes | see particulars |
| 10 May 1991 | **Compass** | lifted the seat limit from twenty to fifty seats | | |
| 23 May 1991 | **Compass** | more discounted seats - on sale to 30 June at $110 Sydney - Melbourne | | |
| 29 May 1991 | Ansett | announced a same day spot sale of Sydney - Perth and Melbourne - Perth tickets for $100 one-way for 100 seats on each flight | see particulars | 12 hours notice |
| **THE WINTER CAMPAIGN - WAR OF ATTRITION** | | | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| June 1991 | . sees the beginning of "suicidal" discounting war.<br>. end of Compass' first financial year in operation. Compass incurs a loss of $16.6 million.<br>. delivery of third aricraft and plans to commence operations to Adelaide | | | |
| 21 June 1991 | **Compass** | initiated the war<br>2 for 1 return trips on any of its services approximately $88 Sydney - Melbourne one way fare | | Initial trip to be between 25/06/91 and 15/07/91 and second trip on same route from 25/06/91 until 30/06/1992 |
| 23 June 1991 | Australian | discount 65% - more than 100 000 seats on a number of routes including Adelaide one day sale for travel from 1/07/91 - 18/09/91 | | tickets were to be paid for within 72 hours of booking and non-refundable.<br>Sydney - Melbourne $99 |
| 24 June 1991 | Ansett | match Australian Airlines discounts - extended sale to 5/07/91 and tickets available for travel until 30 March 1992 - 50% discount on travel within Western Australia | | |
| 24 June 1991 | Australian | Spot $100 one-way fare Melbourne - Perth | | |
| 24 June 1991 | Eastwest | $198 return Sydney - Melbourne, Brisbane or Gold Coast | | |
| 24 June 1991 | **Compass** | New discounts 55-70% - Sydney - Melbourne $88 available for purchase up to 15/07/91 and for travel until 30/04/92. Seats limited and to be paid for within 72 hours of booking | | |
| 24 June 1991 | Ansett | matched Compass fares | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 25 June 1991 | Ansett **Compass** Australian | further discounted fares on Sydney - Melbourne to $85 | | |
| 27 June 1991 | Eastwest | discount Melbourne - Gold Coast to $140, Sydney - Gold Coast to $80  Australian and Ansett matched both fares | | both available for travel until April 1992 |
| July 1991 | • Operations to Adelaide commence.<br>• Discount war becomes more "savage".<br>• Compass forms Compass Airlines Development Limited (CADL) as a vehicle to buy shares into Australian Airlines in case of its privatisation.<br>• To cover for late delivery of 4th aircraft, leased plane from Canadian Airlines. | | | |
| 1 July 1991 | Ansett | discount up to 69% on 156 routes for limited number of seats booked before 13/07/91 and flown by 31/03/92  direct competition between the majors. | | |
| 7 July 1991 | Australian | to undercut Compass entry on 15 July - cut $10 from return fares between Adelaide and other capital cities and $50 between Adelaide and the Gold Coast - offered 300,000 cheap fares until 31/07/91 | | |
| 7 July 1991 | Ansett | matched Australian discounts to Adelaide | | |
| 7 July 1991 | **Compass** | cut fares by an additional $10<br>matched by Ansett and Australian | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 19 July 1991 | **Compass** | discount "**Freedom Fares**" offered to business travellers<br>Sydney - Melbourne - $95 | | tickets on sale until 14/08/92<br>usable **anytime** until 30/06/92<br>no advance specification of day or time of travel |
| 23 July 1991 | **Compass** | Special discounts to Perth<br>Sydney - Perth $170<br>Melbourne - Perth $145 | | |
| 24 July 1991 | Australian | responded to Compass' Perth fares<br>Melbourne - Perth - Melbourne $300 return<br>Sydney - Perth - Sydney $350 return | | tickets on sale to 31/07 and valid until 30/04/92 |
| 24 July 1991 | **Compass** | discounted Perth route fares by further $5<br>Melbourne - Perth $140<br>Sydney - Perth $160<br>also a discounted Melbourne - Perth return fare of $250 for sale and use until August 1991 | | |
| 29 July 1991 | Ansett | extended discount campaign to 212 routes to 14/08/91 with validity remaining at 31/03/92<br>Perth - Melbourne one-way of $125<br>Compass and Australian also amended an extension of the booking period to 14/08/91 | | |
| August 1991 | . Sees the introduction of Frequent Flyer programmes.<br>. Fares war gets more intense.<br>. 4th aircraft starts operations. | | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 5 August 1991 | Australian | new shallower discount schedule on sale until 31/10/91 and validity until 31/03/92<br>- aimed at Compass Freedom Fares<br>- availability of seats was limited compared with Compass' fare | | |
| 15 August 1991 | Ansett | matched Australian's new offer | | |
| 16 August 1991 | **Compass** | extended the deeper discounting until 31/08/91<br>Melbourne - Adelaide reduced fare to $70 (-$5) until end November | | no refunds<br>payment within 72 hours of booking<br>no **restriction** on **availability** |
| 16 August 1991 | **Compass** | Business Plan - introduced to replace the Freedom Fares - available until 12/09/91 for travel until 30/06/92<br>fares higher than the Freedom Fares<br>Sydney - Melbourne $125 c/- $95 - still cheaper than Ansett and Australian's standard economy at $229 | | payment within 72 hours of booking<br>non-refundable but **open dated** in a **company** name and transferable to other flights |
| 22 August 1991 | Ansett | "Bizsaver Fare" similar fares and conditions to Compass' Business Plan | | |
| 25 August 1991 | Ansett<br>Australian | **Frequent Flyer Programmes**<br>introduced FFPs with entrance fee.<br>No immediate response from Compass **BUT** negative advertising pointing out that its new lower fares offered better value than the FF rewards | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| September 1991 | . Fifth aircraft in place, Canadian plane retained.<br>. Interim results for the year published in the press. Compass declares $10.3 mllion loss. Company censured by ASX for lack of disclosure.<br>. Share price goes to $0.35 with $0.50 par value. | | | |
| 4 September 1991 | **Compass** | offered 2 free flights for 1 purchased and used prior to 21/09/91<br>equivalent single fares of:<br>Sydney - Melbourne - $62<br>Sydney - Brisbane - $124<br>Sydney - Perth - $138<br>(Compass later admitted that this sale was a gimmick) | | tickets valid for 1 year<br>**bookable only within 24 hours** of flying |
| 5 September 1991 | **Compass** | introduced sales of books of between five and fifty tickets at discounts of between 25% and 40% depending on the number of tickets - available indefinitely | | |
| 11 September 1991 | Australian | introduced "Money Saver" tickets equivalent to Ansett Bix save and Compass' Business Plan, both of which were due to expire on 12/09/91 available for purchase until 31/03/92 to counter Compass' bulk purchase tickets and was cheaper than Compass' although with more restrictions. | | |
| 11 September 1991 | Ansett | 2 for one to be used prior to 31/10/91 and free membership of Ansetts FF club for anyone who joined the Golden Wings Club in September. | | |
| 11 September 1991 | **Compass** | responded to "Money Saver" by reintroducing the Compass Freedom Fares - cheaper than "Money Saver" available for 1 week for **use** until 30/06/92 | | |

| Date | Carrier | Particulars | Routes | Conditions |
|---|---|---|---|---|
| 17 September 1991 | | Bryan Grey in speech to BIE and BRW Manufacturing Outlook Conference suggests that airfares would rise in Oceober as demand picks up for the period to January 1992. (Power, 1991). *Calling for a truce. **BUT - incumbents "Keeping Compass' head below the water"** | | |
| October 1991 | . Cashflow problems deepen. . Company unable to pay CAA and gets an extension. . Bryan Grey declares ("There was never any doubt that we will survive'). Announces that company is now operating at a profit. | | | |
| 3 October 1991 | Ansett Australian | further round of discounts - available for sale until 20.10.91 and for travel from 20/10/91 - 16/11/91 Sydney - Melbourne - $89 | | |
| 3 October 1991 | **Compass** | then dropped fares to $79 Sydney - Melbourne on sale until 11/10/91 - valid up to end of summer. | | |
| 3 October 1991 | Ansett Australian | matched the fares, validity extended to 30/06/92 | | |
| 3 October 1991 | Eastwest | joined in - cheap seats for sale until 20/10/91 and valid up to 16/11/91 | | |
| 29 October 1991 | **Compass** | introduced 2 for 1 offer available for use until 5/12/91 | | |
| 31 October 1991 | Ansett | anniversary discount schedule available between 11/11/91 and 15/12/91 with Sydney - Melbourne at $89 from $95 | | |

| Date | Carrier | Particulars | Routes | Conditions |
| --- | --- | --- | --- | --- |
| 31 October 1991 | **Compass** | introduced Freedom Fares for sale for 8 days but open dated and usable for 12 months. Sydney - Melbourne at $127 | | |
| 31 October 1991 | Australian | followed Ansett's example | | |
| November 1991 | . Cash flow problems continue.<br>. Major efforts to seek additional equity unsuccessful. | | | |
| 20 December 1991 | Compass collapses, Bryan Grey blames the Federal Government, the Civil Aviation Authority, Ansett and Australian for its collapse. | | | |
| 21 December 1991 | Ferrier Hogson and Company take over the Compass estate. | | | |

# Appendix B

## FINANCIAL FORECASTS

### COMPASS HOLDINGS LIMITED CONSOLIDATED FINANCIAL FORECAST
### ABRIDGED PROFIT & LOSS ACCOUNTS

| | Years Ended 30th June | | | | | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
| | $'000 | $'000 | $'000 | $'000 | $'000 | $'000 |
| Revenue | ---- | 154,250 | 378,264 | 383,409 | 428,092 | 438,251 |
| Operating Profit before Tax | ---- | 20,281 | 104,339 | 107,025 | 125,586 | 134,081 |
| Income Tax Expense | ---- | 1,445 | 41,736 | 42,810 | 50,234 | 53,633 |
| Operating Profit after Tax | ---- | 18,836 | 62,603 | 64,215 | 75,352 | 80,448 |
| Retained Profits Brought Forward | ---- | ---- | 7,836 | 9,136 | 9,304 | 11,349 |
| Profits Available for Appropriation | ---- | 18,836 | 70,439 | 73,351 | 84,656 | 91,797 |
| Divident Payable | ---- | 11,000 | 61,303 | 64,047 | 73,307 | 79,979 |
| Retained Profits Carried Forward | ---- | 7,836 | 9,136 | 9,304 | 11,349 | 11,818 |

### BALANCE SHEETS

| | As at 30th June | | | | | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
| | $'000 | $'000 | $'000 | $'000 | $'000 | $'000 |
| Issued Capital | 55,000 | 55,000 | 70,000 | 70,000 | 70,000 | 70,000 |
| Retained Profits | ---- | 7,836 | 9,136 | 9,304 | 11,349 | 11.818 |
| Shareholders Funds | 55,000 | 62,836 | 79,136 | 79,304 | 81,349 | 81.818 |
| Unearned Revenue | 700 | 18,883 | 29,425 | 29,425 | 33,921 | 33.735 |
| Trade Creditors | ---- | 5,510 | 5,480 | 5,480 | 6.211 | 6.181 |
| Provisions | 66 | 13,247 | 72,370 | 71,178 | 84.743 | 89.664 |
| Total Liabilities | 766 | 37,640 | 107 275 | 106,083 | 124.875 | 129.580 |
| Total Liabilities & Shareholder Funds | 55,766 | 100,476 | 186,411 | 185,387 | 206.224 | 211.398 |
| Fixed Assets | 5,582 | 35,470 | 34,290 | 33,363 | 32.101 | 30.746 |
| Security Deposits | 3,981 | 9,873 | 10,405 | 19,372 | 16.706 | 18.039 |
| Trade Debtors | 335 | 30,487 | 30,930 | 30,955 | 35.749 | 35.641 |
| Development Costs | 10,535 | 20,466 | 15,833 | 11,199 | 6.565 | 1.931 |
| Cash | 35,333 | 4,180 | 94,953 | 90,498 | 115.103 | 125.041 |
| Total Assets | 55,766 | 100,476 | 186,411 | 185,387 | 206.224 | 211.398 |

### PER SHARE DATA

| | Years Ended 30th June | | | | | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
| | $'000 | $'000 | $'000 | $'000 | $'000 | $'000 |
| Earnings per share (cents)* | ---- | 17.1 | 44.7 | 45.9 | 53.8 | 57.5 |
| Dividend payable pershare (cents)* | ---- | 10.0 | 43.8 | 45.7 | 52.4 | 57.1 |
| Franking level (%) | ---- | ---- | 52.0 | 100.0 | 100.0 | 100.0 |

*Adjusted for the exercise of 30,000,000 options by Keymaze Pty. Limited.