

## **LOW COST AIRLINES IN SOUTH EAST ASIA: A VIEW FROM SINGAPORE**

**JOAN C. HENDERSON**  
Nanyang Business School  
Nanyang Technological University  
Singapore

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*The paper is concerned with the concept and characteristics of low cost airlines which are a well established sector in North American and European civil aviation industries, but a fairly recent phenomenon in South East Asia. Trends within the region are discussed with particular reference to the case of Singapore which has seen an expansion in low cost airline activity. Further growth seems possible and likely, although new entrants are shown to face both opportunities and problems. The Western business model appears to be applicable in a regional context, yet some modifications may be necessary to suit the different conditions in the market and those prevailing more widely.*

*Airline deregulation, low cost airlines, Singapore*

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### **INTRODUCTION**

Considerable attention has been given to the relatively new style of airlines which differentiate themselves from traditional carriers by cutting costs as far as possible, partly by reducing services to a minimum. The policy enables them to charge exceptionally low prices and create new markets of air travellers. Various labels are applied to these operators such as budget, low cost, low fare and no frills, but none are entirely satisfactory. All types of airline are now vigorously pursuing cost cutting and many frequently engage in price competition, while some non-essential services may be provided by those categorised as belonging to the no frills group. Low cost airline does, however, appear to be one of the most commonly cited phrases and is employed hereafter.

Low cost airlines are already a powerful force in Europe and North America where they have transformed the civil aviation industry. Some observers maintain that the approach to running an airline is not feasible in Asia because of fundamental differences between its operating environment and that of the West. Such arguments have become less convincing in recent years due to an expansion in Asian low cost airline activity. This paper is concerned with trends in the sector in South East Asia with particular reference to Singapore where low cost traffic increased in 2004 when three airlines were set up. Work also commenced that year on an airport terminal for the exclusive use of low cost carriers in anticipation of further growth. However, success is not guaranteed and some entrants have encountered difficulties which raise questions about the overall applicability of conventional low cost airline strategies.

After a summary of the low cost airline phenomenon, conditions in South East Asia are briefly reviewed and prospects in general are assessed. The development of the industry in Singapore

Address correspondence to Joan C. Henderson, Nanyang Business School, Nanyang Technological University, Nanyang Avenue, Singapore 639798. Tel: 65 6790 6116. E-mail: ahenderson@ntu.edu.sg

is then explained and the performance of the new airlines is described. A final conclusion considers the implications of events in Singapore, what they reveal about the opportunities and constraints facing low cost airlines within the region and whether Eastern experiences are leading to a redefinition of the Western business model. Findings are derived from published and electronic media, direct requests to companies for information about passenger volumes and financial performance going unheeded, and the limitations of these sources are recognised.

## **LOW COST AIRLINES**

Characteristics of low cost airlines are fleets comprising the same design of plane, high aircraft utilisation, single class of travel, free seating, Internet booking and electronic ticketing. Secondary airports are commonly used because of less expensive fees and planes are turned around at speed to maximise flying hours. Any refreshments or additional amenities must usually be paid for and labour, likely to be non-unionised, is kept to a low level with staff expected to multi-task. Passengers, rather than cargo, are carried on point to point routes within a three to four hour radius and the emphasis is placed on simplified and efficient organisations and procedures (Doganis, 2001; Donne, 2000; Lawton, 2002). As a result of cost savings, ticket prices are substantially cheaper than those sold by more conventional airlines and the potential market has been enlarged to include those who previously could not afford to fly.

The emergence and evolution of low cost airlines in Western markets has been a subject of interest to academics, practitioners and the popular and more specialised press which frequently cite Southwest Airlines in the USA and Ryanair in Europe. They are agreed to have pioneered the concept (Calder, 2002; Kangis and O'Reilly, 2003), but are not identical and Gillen and Lall (2004) contend that the American example has been easier to copy. Regulatory barriers, the presence and strength of competitors and market size and composition are identified as critical to entry and success. Francis *et al.* (2004) add the involvement of entrepreneurs, airport availability and capacity and exploitation of the Internet as a distribution channel to the list of pre-requisites for the spread of low cost airlines.

The low cost airline product has its detractors who criticise features such as an 'occasionally misleading pricing policy' which excludes compulsory charges and taxes from advertised fares. In Europe, customers have been 'doomed to visit destinations that they did not know they wanted to visit, from obscure airports' (Strategic Direction, 2003). Booking conditions are inflexible, complex itineraries are impossible and the benefits of airline alliance membership are denied to businesses and their customers. There may be further concerns about safety owing to stress amongst flight crews and tight schedules (The Independent, 2005), as well as ageing equipment. Nevertheless, passengers seem willing to tolerate any perceived disadvantages in exchange for inexpensive air travel and some may prefer to avoid the congestion of overcrowded hub airports (Barrett, 2004a).

The popularity of low cost airlines has had implications for airports (Barrett, 2004b; Francis *et al.*, 2005) and previously dominant airlines which are variously termed full service, network, incumbent, legacy and major carriers. These companies are being compelled to revise modes of operation in response to the competition posed by low cost rivals and some are adopting certain of their techniques, with a degree of convergence (Franke, 2004). A number have formed their own low cost subsidiaries, although several of these have failed alongside others without such connections.

With regard to determinants of long term survival, commentators advise that low cost airlines do not overlook elements besides price because fare and cost reductions can be emulated by

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competitors (Lawton, 1999). While a new entrant charging bargain rates will have an immediate advantage, a proliferation of low cost airlines makes differentiation imperative in order to encourage loyalty to the company and not to the cheapest price (Gillen and Morrison, 2003). There are also opportunities for widening the market to incorporate more price sensitive business travellers (Mason, 2000). Such developments are perhaps aspects of an evolutionary process which may favour homogenisation as low cost and full service airlines come increasingly to resemble each other.

The relevance of North American and European illustrations for other parts of the world is a matter for debate and some analysts have speculated that the low cost model and variants of it are unworkable elsewhere (Thomas, 2002; Pinkham, 2003). Others maintain that these arguments are being confounded in Asia by mounting commercial interest (Kua and Baum, 2004) and responsive local consumers who exhibit the same attributes as their Western counterparts (O'Connell and Williams, 2005). Calculations that travel on low cost airlines accounts for less than 5% of the total Asian market, compared to 25% in the USA and 40% in the UK and Ireland (Francis *et al.*, 2005), can be interpreted in contradictory ways. The figures may be indicative of considerable untapped potential, but can also be seen as evidence of the limitations which have hampered enlargement of the low cost sector in the past and may continue doing so in the future. Issues of the viability of low cost strategies and whether Western approaches can be replicated in locations such as South East Asia are returned to after the following account of recent trends in the region.

### **LOW COST AIRLINE ACTIVITY IN SOUTHEAST ASIA**

Air transport overall has been expanding at above average rates across the Asia Pacific region, despite the series of crises which have confronted the global civil aviation industry. There was strong recovery in 2004 from the damage caused by the Severe Acute Respiratory Syndrome (SARS) virus in 2003 and passenger traffic to and within the region is forecast to grow by 7.1% and 8.3% annually until 2008 (IATA, 2005). Boeing believes that Asia Pacific countries will take possession of 7,200 new passenger aircraft in the next 20 years, making them the second largest market after North America (CNA, 2005).

Low cost airlines are also growing in number and an estimated 16 have started flying in Asia since mid-2003 (Dow Jones, 2005; Fullbrook, 2005a), including those headquartered in South East Asian countries such as Indonesia, Malaysia and Thailand. Air Asia, dating from 2001, is regularly quoted to illustrate what can be achieved and became a public company in 2004, with 35 planes serving 54 routes by 2005. It is aiming to construct a pan-regional network, setting up subsidiaries in Indonesia and Thailand. The founder and CEO is an entrepreneur with a background in the music industry who is sometimes hailed as an Asian Richard Branson. The Malaysian airline carried 1.2 million passengers and had a load factor of 70% in 2004-2005 when its net profits more than doubled to S\$49.7 million (The Straits Times, 2005a).

Other new airlines are aspiring to follow Air Asia's success and share many of the defining features of their equivalents in the West. However, they tend to have relatively small fleets and appear willing to offer longer flights. There were even reports in 2005 of a new Hong Kong airline which will sell tickets to European destinations such as London and Milan (TTG Daily News, 2005). Some are prepared to invest in supplying a restricted range of services on the ground and in the air, one in Indonesia marketing itself as a 'boutique' and 'value added' airline (Adam Air, 2005).

The movement has been predominantly led by the market and the appeal of South East Asia to low cost airlines is partly explained by a population in excess of 500 million. Many residents are discouraged from travelling by surface transport due to geographical barriers, lengthy distances and journey times and poor land and sea communications. Economic advances and social change are creating a new middle class of consumers who are enthusiastic about leisure travel and are sufficiently affluent to indulge in it, while rising standards of living are also bringing the cheapest air travel within reach of lower income groups.

Larger countries have an assortment of regional airports which can handle the planes commonly flown by low cost airlines and the pace of new airport construction is yielding fresh opportunities. Authorities in Bangkok and Kuala Lumpur are both examining proposals to devote their old airport sites, which are better located in terms of access to the city centres than the newer facilities, to low cost flights.

In addition, the political climate is altering and governments are expressing greater willingness to work towards improving and expanding domestic, regional and global air transport links. Attempts at closer economic and political integration amongst the ten member states of the Association of South East Asian Nations (ASEAN) have prompted an easing of restrictions on intra-regional trade, encompassing the airline industry. A 'roadmap' has been prepared to direct greater liberalisation of passenger and cargo services (ASEAN, 2005) and negotiations about a regional action plan for the period up until 2015 are ongoing. One underlying motive is the desire to boost tourism which is critical to most ASEAN economies (CAPA, 2002).

The above review suggest that a new era may have begun in civil aviation in the region, reflected in amounts of investment in existing and planned low cost carriers (CAPA, 2004). More such airlines are flying and passengers now have a diversity of carriers and routes to choose from, as well as the chance to purchase tickets at historically low prices.

It would seem therefore that there is a role for low cost airlines in South East Asia, but it must also be recognised that some new ventures are struggling and there is a feeling that a degree of consolidation could ensue. Uncertainties have been compounded by dramatic rises in fuel prices in 2005, placing severe financial pressure on airlines and inhibiting entry, although this is a universal phenomenon and not confined to low cost operators. The sustainability of individual airlines and the sector as a whole are thus still to be determined and are discussed in the next section. The account also reveals divergences between market conditions in the West and East of consequence for the success of the low cost model in the latter arena.

#### **FUTURE PROSPECTS OF SOUTHEAST ASIAN LOW COST AIRLINES**

Opinions are divided about the future of low cost airlines in the South East Asian region, reference often being made to the difference in its situation and that of North America and Europe. The previous section has indicated certain commonalities in terms of demand and provision, but there are marked contrasts. The Asian population may be large and wealthier, but per capita incomes and Internet usage remain low and airlines cannot rely on online distribution channels as happens overseas. Departure taxes may also deter frequent outbound travel in some instances and nearly all residents leaving Indonesia must pay one million rupiah or almost US\$100, equal to the price of a discounted return air ticket to neighbouring countries (The Jakarta Post, 2000).

Low cost airlines have to deal with competition from full service carriers and this varies in the East and West. Asian industry representatives maintain that Asia does not suffer from the

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stagnating traffic, high labour costs, obstructive unions and inefficient aircraft utilisation which characterise established European companies. Several Asian majors have high productivity and competitive cost structures so that differentials between their fares and those of low cost airlines are narrower than in Europe and the USA. They also have thriving cargo businesses, making them less dependant on passenger revenues. Asian airlines collectively earned approximately US\$2 billion in 2004, strengthening their resistance to the commercial threat of the low cost sector and making it harder for new enterprises to flourish (AAPA, 2004). Airlines of other regions have proved more vulnerable and this is often due to financial weakness, the American industry losing about US\$8 billion in 2004 (The Straits Times, 2005a).

Incumbents in South East Asia, some renowned for deep discounting, are already selling destinations attractive to low cost carriers with substantial rivalry on the busiest city to city routes. This means that low cost entrants must match or undercut existing low fares and also explore new routes, possibly involving flying times of five hours or more when in-flight services acquire greater importance (Hooper, 2005). Main airports too compete fiercely for airline customers and may set charges at a level which undermines the financial rewards of flying to peripheral airports. Suitable secondary airports close to dense population centres may not be as abundant as in the West, restricting route selection and growth options for low cost airlines.

Although there are signs of official support for low cost airlines and an appreciation that they have a place in contemporary civil aviation, slow advances towards a more liberal regime is a further obstacle which does not pertain in North America and Europe (Tae, 1997). Despite ASEAN's professed commitment to the deregulation cause, regulation is still extensive and governments are unenthusiastic about radical reform. Restrictive bi-lateral agreements designed to protect national industries persist and Indonesian authorities actually banned low cost flights to principal cities in 2005, generating some antagonism and talk of retaliation (CNA, 2005). There is also a tendency for officials to seek to bolster weaker flag carriers in a way which would be contradictory to anti-competitive regulations imposed elsewhere (The Financial Times, 2005a). Domestic deregulation is more acceptable, but low cost airlines flying internationally need comparatively open skies and frequent departures which are not facilitated in a highly regulated environment.

Even if all the above and additional barriers are surmounted, it is necessary for low cost airlines in Asia Pacific as a whole to formulate a 'long term strategy for market penetration, survival and growth' (AAPA, 2004). Differentiation, a strong brand and competitive advantage are crucial as passenger choice is extended (Fullbrook, 2005b), but their attainment may be elusive and expensive. This is, however, a test for most low cost carriers irrespective of their geographical area of action.

The low cost airline industry in South East Asia is thus in a nascent and dynamic phase (CAPA, 2004). Although there are dilemmas to resolve, progress made to date implies that the framework borrowed from successful companies outside the region cannot be dismissed as unsuitable. Nevertheless, topics such as the effectiveness of its implementation (with or without modification) and the number of carriers which can be accommodated require longer term monitoring before any firm conclusions can be derived. The changing circumstances in Singapore afford further insights into the evolution of the sector and some of the opportunities and problems there are now outlined.

## **LOW COST AIRLINES IN SINGAPORE**

The government investment group of Temasek Holdings has a 57% stake in Singapore Airlines (SIA) which acts as the national carrier, but there is an official policy of promoting competition in the civil aviation industry and this has been extended to the low cost sector (IATA, 2004). Commitment to low cost airlines was demonstrated by an announcement in mid-2004 about the construction of an S\$45 million dedicated terminal. When completed in 2006, it will have the capacity to handle 2.7 million passengers annually and fees will be about 25% below those of other terminals (Goh, 2005). Approval was also granted for three low cost airlines (Jetstar Asia, Tiger Airways and Valuair) which started flying in 2004, joining SIA and its wholly owned subsidiary of SilkAir which has a regional timetable. The carriers are all based at Changi Airport which functions as a regional air transport hub and gateway. Low cost flights constituted 7% of its total traffic by late 2005, with 175 weekly services to 15 cities. However, the country's three low cost airlines had a somewhat turbulent first year which is described below.

### **Valuair**

Valuair commenced flights in May, making it the first low cost airline in Singapore, and was led by a former senior manager from SIA. Backing principally came from Singaporean businessmen and the amount of original financing was US\$19.4 million, with an attempt to double the company's capital at the end of 2004 (The Edge, 2004). The airline's positioning was distinctive as reflected in its assertion that 'there are full service airlines, budget airlines and then there is Valuair. We challenge the norm' (Valuair, 2005).

Attention was given to service and features such as complimentary refreshments, dedicated seats, a hand luggage allowance of 20 kg and seats with a 32 inch pitch (three inches more than the usual low cost carrier seat). Valuair flew to Bangkok, Hong Kong and Jakarta as well as the Chinese destinations of Chengdu and Xiamen and Perth in Australia. The fleet of four new Airbus A320s thus operated on longer routes, with journeys in excess of five hours, and there were plans to serve other more distant places in Eastern Australia and North East Asia with larger planes.

However, there were media reports that Valuair had almost exhausted its reserves and was looking for funding, having lost an estimated S\$4.1 million after seven months. Problems were cited of mounting oil prices, relatively high fares compared to those charged by other low cost operators and full service rivals, discounting and load factors of 60% (The Financial Times, 2005b; The Straits Times, 2005b; The Straits Times, 2005c). The resignation of the CEO was reported in April and the company could not indicate when it would attain profitability (The Straits Times, 2005d).

### **Tiger Airways**

Tiger Airways, in which SIA had a 49% interest, commenced flights in mid-2004. Other shareholders were Indigo Partners (24%), the private investment firm of Ryanair's founder known as Irelandia Investment (16%) and Temasek Holdings (11%). It was seen as a defensive reaction by SIA to the new style operators, represented originally by Air Asia (The Straits Times, 2003), conforming to a more common pattern whereby a Southwest 'copycat' provokes a legacy carrier into setting up its own low cost subsidiary (Francis et al, 2004).

Tiger Airways had four new Airbus A320s and at first flew to Bangkok, Chiang Mai and Hat Yai in Thailand and Manila. Phuket in Thailand, Hanoi and Ho Chi Minh City in Vietnam, Padang in

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Indonesia and Macau were added later to be followed by Darwin in Australia. It was flying to ten cities in six countries at the end of 2005. A 2004 press release revealed the company's ambitions to have 12 aircraft by 2006 and grow annually by 25-35% in its first five years (Tiger Airways, 2004).

The airline had a free seating policy, permitted 15 kg of cabin baggage to be carried without charge and passengers had to purchase onboard food and drinks. Its stated business strategy was one of 'market stimulation – creating opportunities for new travellers and empowering budget-conscious people to fly more often; stringent cost controls throughout operations so that fares can be kept low for travellers; capacity utilisation – maximising the number of sectors served per plane per day with efficient air traffic planning'. The plan was, like Air Asia, to form a network across the region and enter into joint ventures with overseas partners to overcome the impediments of rigid bi-lateral agreements (Tiger Airways, 2005a).

Routes bypassing Singapore were a part of its vision of the future (The Business Times, 2005) as well as those of a 'less conventional' nature (Aviation Daily, 2005), with India, South China and Cambodia all mentioned. Commentators noted a trend whereby the company was taking over services abandoned by SIA and SilkAir such as that to Krabi in Thailand which it began flying in October 2005. Flights between Macau and Manila were also due to start at that time, leading to speculation that it might be exploring the establishment of a second home outside of Singapore in order to spread risks and provide an avenue for growth (Wikipedia, 2005).

The company carried half a million passengers in its first year and set a target of three million for 2006 when it would take delivery of five aircraft and occupy the new budget terminal at Changi (The Straits Times, 2005e). Its mission was to be the 'Ryanair of Asia' and attain profitability by 2007, two years later than originally hoped (The Straits Times, 2005f).

### **Jetstar Asia**

The third low cost operator was Jetstar Asia, headed by a CEO from Qantas, which began flying in late 2004. Its backers were Qantas, with a share of 49%, and Temasek Holdings (19%) and two Singaporean businessmen (32%). The company sought to fly within a five hour radius of Singapore to Hong Kong, Jakarta and Surabaya in Indonesia, Manila, Pattaya in Thailand, Shanghai, and Taipei. Its fleet comprised four new Airbus A320s and the aim was to enlarge this to 20 planes by 2007 (The Edge, 2004). There was advanced allocation of seats and a 20 kg hand luggage allowance, but travellers were required to pay for refreshments and in-flight entertainment (Jetstar Asia, 2005).

An inability to agree on landing rights, especially at desired Chinese and Indonesian locations, led to an announcement in March 2005 that the intention of adding four planes by the beginning of 2006 would not be realised. The Pattaya service stopped and the route network consisted of Bangkok, Hong Kong, Manila and Taipei in July 2005. Company losses were estimated to be S\$51 million during the seven months since flights had begun (The Straits Times, 2005b).

### **Orange Star**

The problems encountered by Jestar Asia and Valuair resulted in merger and the creation of a holding company named Orange Star in July 2005. The media expected that Qantas and Valuair shareholders would own between 40% and 49% and 20% of the company respectively. The latter included Malaysia's Star Cruises, Asiatravel.com, Temasek Holdings and individual businessmen

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(Flight International, 2005). The two airlines were to continue to function separately, with few major changes in the immediate future (The Financial Times, 2005). Nevertheless, there would be a rationalisation of staff and routes to maximise efficiency and management spoke of a 'single model'. The former CEO of Jetstar Asia was put in charge of both operations and the company was led jointly by the CEO of Qantas and Chairman of Jetstar Asia. Qantas was also said to be providing most of a capital injection of about S\$50 million (The Straits Times, 2005g).

Following the merger, Valuair introduced flights to Surabaya and withdrew those to China. Jetstar Asia commenced services to Phuket and Bangalore and Kolkata in India in late 2005 when approval was being sought to fly to Cambodia. The intention was that Valuair would focus on Indonesia and Jetstar Asia would concentrate on India and other markets, with a review of common flights to Bangkok and Hong Kong. The combined entity was due to take possession of its ninth plane in November 2005. The decision was made that Jetstar Asia would code-share with Qantas and this was hailed by Tiger Airways as a sign of its demise as a genuine low cost airline to become the 'regional services arm' of the Australian company (Tiger Airways, 2005b). It was also agreed to code-share with Myanmar Airways International, interpreted as a step towards direct rivalry with Silk Air (Poon, 2005).

### CONCLUSION

Singapore's low cost carriers took to the air with great enthusiasm and much publicity in 2004. The new companies endeavoured to be innovative, within the broad parameters of the low cost structure, and distinguish themselves by a combination of price, service and routes. Valuair had the advantage of being first mover, aiming to strike a unique balance between full and minimal service, and Jetstar Asia also chose to provide some services. All stressed their competitive fares and offered or planned to offer destinations with flying times exceeding four hours, contrary to the conventional low cost practice.

However, concerns about financial performance were reported and Valuair, unlike Jetstar Asia and Tiger Airways, did not have the backing of a larger airline. In addition to matters of finance, regulatory barriers could have impeded the development of route networks with landing rights and capacities depending on international agreements which take time to negotiate and execute. On available routes such as Singapore to Bangkok, there may have been a danger of over supply with keen price competition amongst all operators, including full service airlines. Initial optimism was thus tempered by setbacks, leading to a revision of plans and consolidation.

Discussion of the situation in Singapore provides an interesting perspective on the growth and prospects of the low cost air travel industry in South East Asia and demonstrates some of the commercial opportunities and operating constraints. Like other regional low cost airlines, Singapore carriers are appreciative of and anxious to exploit unrealised demand. They must, however, overcome sometimes high regulatory hurdles and ensure that they possess the necessary resources to sustain them through the start up stage and any subsequent periods of adversity.

Unlike low cost ventures in neighbouring states, Singapore airlines do not have a sizeable home market. The population is about four million compared to 219 million in Indonesia and 25.6 million in Malaysia. The republic also occupies only 626 sq km of land and there is no call for domestic air travel. The affluence of Singapore's residents and their predisposition to travel does not fully compensate for these limitations which result in less room for new airlines and the need to cultivate overseas markets. Low cost airlines in Singapore have therefore to be especially creative

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if they are to prosper and must perhaps contemplate the establishments of overseas bases, either independently or in conjunction with local enterprises.

The Singapore case indicates that Western forms of low cost airline operation are applicable in a non-Western environment. Types of competitive pressures are similar in the two markets and carriers share certain prerequisites of success. Long term financing and strategic planning would seem crucial factors in sustainability. The containment of costs is also critical and becoming more challenging in an era of escalating fuel prices and spending on security. Building customer loyalty is essential in view of the degree of competition as are the ability to innovate and react quickly to rapidly changing circumstances. Sound management, accompanied by imagination and vision, has also been demonstrated to contribute to the setting of a clear direction and realisation of company goals. Experiences in the full service business may not always be appropriate within the low cost context, despite the trend towards convergence observed earlier.

Determinants of survival and success transcend international borders and apply in both Eastern and Western domains, but differences in the economic, social, geographic and political arenas as well as commercial and regulatory regimes must be taken into account. These have given rise to contrasting dynamics and the defining characteristics of South East Asia collectively and in terms of member countries represent a framework for civil aviation activity as a whole which does not correspond exactly to that found elsewhere. The industry's vulnerability to crises triggered by externalities such as natural disasters, health scares and various forms of instability must also be addressed given their pattern of recurrence in the region and capacity to disrupt tourism.

The low cost sector in South East Asia is at an earlier stage of evolution than those in Europe and North America and it may be premature to identify instances of good practice due to relatively short corporate histories. At the same time, there is evidence of achievement and progress in the sector's development and the pioneering efforts of Air Asia should be acknowledged. The challenge now is to make the most of the opportunities and strive to overcome the constraints, learning lessons from the success stories and instances of failure which have occurred regionally and in other parts of the world.

It is also important to note that the inherited model is being subjected to reassessment with attempts by some companies to introduce revisions to the original concept. This process is likely to continue as the low cost business matures and a distinctively South East Asian type of low cost airline could emerge with particular features which include a certain level of service, longer routes and partnership arrangements. Growth also depends on national and international government action to lift current restrictive regulations. Such a move would greatly assist in fulfilling the potential of this comparatively new component of the tourism industry which is generating interesting possibilities for travel in the South East Asian region.

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