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ANTI-COMPETITIVE MARKETING PRACTICES IN THE AIRLINE INDUSTRY: A PUBLIC POLICY PERSPECTIVE

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ABSTRACT

Consumers, airlines and the economy as a whole have benefitted from airline deregulation. Government regulation was replaced by competition as the protector of the consumers. Airlines continue to pursue marketing strategies which reduce competition and as act as barriers to new entrants. This paper reviews some of those strategies and suggest actions by which policy makers might encourage competition.

INTRODUCTION

Since the deregulation of the airline industry, during the late 1970s, consumers have benefitted from competition. It has been estimated that consumers benefitted in the amount of about six billion dollars per year in lower fares. Most of this saving has gone to vacation travelers and to travelers in major markets (USDOT 1998). Business travelers have benefitted from increased flight frequencies. As air travel has increased, airlines have expanded and modernized their fleets. Operating efficiencies gained in the highly competitive domestic market have made U.S. carriers nearly invincible in international markets. (It should be noted that airline deregulation has also resulted in larger, more crowded aircraft, lower spending on in-flight food and service and crowded airspace resulting in delays.)

The airline industry is rapidly changing. Most major U.S. carriers are focusing more on international flights than ever before (Anderson 1998a). Recent "open sky" agreements open new markets to U.S. flag carriers and allow foreign carriers more access to our international markets (Gourdin 1998). (Recent declines in the economies of the Asia rim and of Latin America have caused some carriers to rethink this move to dependence on international flights.) The NAFTA agreement has given Canadian and Mexican carriers increased access to U.S. markets (Kearney & Robinson 1993).

Airline industry policy makers are faced today with marketing strategies and public policies which threaten to reduce the level of competition in the industry. There needs to be a discussion of what level of competition is good for consumers, the airline industry and the nation. There also needs to be a discussion of what public policies need to be adopted to reach this level of competition in a changing world. This paper will outline the various threats to competition and list some of the options policy makers might have available.

The airline industry is important not only as an industry, in itself, but also as an industry which has a major effect on suppliers, customers and complementary industries. Low air fares and frequent service are prerequisites for much of the tourism and convention industries. Aircraft makers, food suppliers and travel agents depend on the large volume the industry presently enjoys. The industry is also important as an example and testing ground for policies being proposed in other industries. The international alliances described in this paper are similar to alliances being proposed or developed in such diverse industries as telecommunications, banking, insurance and financial services. The success or failure of this industry under deregulation could effect the deregulation of and the shape of such industries as local phone service, electricity and telecommunications.

DEREGULATION AND COMPETITION

Prior to deregulation, airlines were regulated by the Civil Aeronautics Board (CAB) in three major ways; market entrance, flight frequency and pricing. New

carriers were basically barred from starting operations. Existing carriers found it difficult to add new city pairs or to change their frequency of service in existing markets. Prices changes had to be approved by the CAB and applied to all of the carriers in a market. Price discounts were limited and available only to groups such as students and military personnel. Airlines tended to compete on customer service elements, such as meal service, seat comfort and movies. The government directly subsidized service to a few small communities and indirectly subsidized service to many more by allowing high profit levels in major markets and requiring each carrier to serve some money losing smaller markets.

Under deregulation, airlines were free to serve what markets they wanted, with flight frequencies they wanted and at the price they wanted. Most carriers adopted similar strategies in response to deregulation. They reduced or abandoned service to small unprofitable markets, and increased prices in those small markets they continued to serve (Kearney 1988). They decreased prices in major markets and entered new long-haul high-density markets. Most carriers began offering discounts subject to complicated restrictions to differentiate business and non-business travelers. They also changed the service level they offered the consumer. They increased the number of seats per aircraft by reducing space between seats and the size of the seats, increased the load factor (percentage of available seats filled by paying customer), and reduced spending on meals and amenities (Kearney 1988). Most carriers soon started to build hub and spoke route systems to gain operating efficiencies and to ensure "on-line -feed" (continuation of passengers over connecting flight segments) (Meade 1988).

The strategies adopted by the major airlines did not insure success. While carriers had previously made money in long-haul high-density markets, high levels of competition brought price levels in these markets down. Travelers shopped for price and showed little or no brand loyalty. Rapid expansion strained airline finances. Within a few years of being deregulated, most airlines were losing money (Meade 1988).

During the early days of deregulation, new carriers entered the market and some carriers which had previously been air taxi, regional, or charter carriers expanded their operations to become major airlines. Some were successful. Some were not. For the first time since the 1930s, airlines were allowed to survive or fail on their own. Some of the new carriers went under in a matter of months; some old carriers entered bankruptcy. One problem that new entrants presented is that most operated at lower cost than their older, larger competitors, making price competition a threat to major carriers (Kearney 1988).

By the mid 1980s, most carriers were adopting strategies which were designed to reduce the need to compete on price. Frequent flyer programs were introduced that tended to tie the most valuable customers to one carrier, creating artificial brand loyalty. A series of mergers created regionally dominant carriers and eliminated regional competitors (Northwest/Republic, TWA/Ozark, USAir/Piedmont) (Kearney 1988). Other mergers were attempts to feed passengers into larger route systems (PanAm/National, Delta/Western). Reservation systems were employed to give host carriers an advantage (Meade 1988). New carriers were denied access to airports under leasing arrangements between the airlines and the airport operators (Kearney 1988).

CONTESTABILITY

When airlines were deregulated, there was an expectation that competition would take the place of regulation in providing cheap, high quality service to airline passengers. The mobile nature of air transport suggested that no carrier would be able to dominate a market and reap monopoly profits. If prices were high in a market, other airlines would enter and compete excess profits away. Since it was assumed that airlines would have comparable costs of production, competition would provide reasonable, but not exorbitant profit levels (Bailey 1981).

The mobility of capital investment was also assumed to provide "contestability," that is, the threat of entry would keep prices down in markets which were being served by one or few carriers (Baumol 1982). This is important in public policy analysis because policy makers are shifting away from looking at the number of competitors in a market, to examining the ease in which new competitors can enter the market. Carriers would be able to charge more, but not substantially more, in less dense markets which their competitors choose not to serve.

These assumptions have been found to be, at least partially, wrong. Operating costs vary dramatically from airline to airline. New entrant carriers and those which have been through bankruptcy tend to have much lower operating costs than the older major carriers. This has

allowed some carriers to dominate individual markets. While these lower cost carriers have used price to gain control of these markets, there is little market threat to their ability to raise prices after gaining control because higher cost carriers know that they can't hope for a win or even a tie in a price war. Major carriers have resorted to buying or forming alliances with lower cost carriers to allow the major carriers to compete in lower density markets. These carriers often use code sharing (giving the smaller carriers flights flight numbers of the larger carrier) and even name changes (American Eagle, United Express) that disguise their status as entities separate from the parent company.

The issue of contestability is a more controversial topic. Consensus among economists and policy makers is that airline markets are partially contestable; that is, carriers can enter new markets, but not with perfect freedom and often at a disadvantage to incumbent carriers. This allows higher than expected yields and load factors in many markets. The question for policy makers is what are the barriers to contestability (entry) and what can be done to remove or mitigate the effect of these barriers.

BARRIERS TO CONTESTABILITY/ENTRY

Some entry barriers can be seen as natural. That is, that these barriers exist as part of the nature of the industry and there is little policy makers can, or should, do about these. Some of these natural barriers are:

> The long term effects of advertising and marketing as an investment in name recognition and airline image. The cumulative effect of decades of advertising is a major advantage for incumbent carriers. Casual consumers know a few major airlines. While travel agents and frequent flyers might be aware of new entrants and price or service advantages they might bring, less informed passengers are more likely to think of airlines they have known for years (Kearney 1988).

> The advantage to being the largest carrier at an airport or in a city pair market. There is a relationship which has been documented for years between the largest carrier in a market and the load factor of that carrier. That is, the carrier offering the most seats in a market will receive a more than proportional number of paying passengers, all other things being equal. This is related to the factor described above, larger carriers are often carriers which have advertised in the market for years, but it also a function of flight frequency. The carrier which offers the most seats in a market usually offers the most flights. The carrier which offers the most flights is most likely to offer a flight at or near the time of day any individual passenger wishes to fly (Kearney 1988). If consumers or travel agents are able to make convenient reservations with the first airline they investigate, they are unlikely to continue their search. Business travellers are likely to pay more for a more convenient time and are not likely to shop for cheaper fares at less convenient times.

>The role of international gateway flights and regional feeder flights in establishing airport and city pair dominance. Most airlines are still regional. They tend to have their smaller markets concentrated in some parts of the country, even if they serve long haul markets to other parts of the country. Passengers prefer single airline service even if they have to change planes on a trip. The same is true of international passengers. They may have to change airplanes, but most prefer to keep the same airline through the trip. The feed of passengers from international and short haul flights give some airlines an advantage of a base level of business before they have to compete with other carriers in a market. This occurs at a natural level. It will be discussed below that some carriers have also tried to stimulate artificial levels of on-line-feed through marketing strategies.

While the barriers listed above are naturally occurring, other barriers are the result of conscious planning. These attempts to create artificial barriers to competition have been implemented, in some cases, in spite of government concerns. In other cases, these programs have been implemented with the active participation of government agencies. While there is little that can reasonably be done about the natural barriers to competition, discussed above, the artificial barriers are subject to regulation. These artificial barriers include:

> Frequent flyer programs. Frequent flyer programs create artificial brand loyalty, especially among business travelers. The cumulative nature of the rewards (the more miles you have, the much more they are worth) lead passengers to choose the airline with which they have mileage accounts , not the one offering the best deal. In the case of business passengers, when someone else is paying for the flight, there is a strong incentive to choose flights to maximize frequent flyer mileage credits. This moves the major carriers, especially the carrier with the largest presence in a given city, away from price competition and insulates them, somewhat, from lower cost carriers.

>Travel agent commission overrides. It is the

practice of airlines to pay a higher level of commission to travel agents who do more than a specified percentage of their business with that airline. Since most travel agencies are local, these overrides can create an advantage in city and city-pair markets for larger carriers. The travel agent is given an incentive to put passengers on the preferred airline, whether or not that airline offers the best price or service for the passenger. With the complicated nature of airline reservation programs, most passengers will never realize that they were misled by the travel agent.

> Airport capacity restrictions. Some of the busiest airports (The airports that airlines most want to serve.) in the country are under restriction by the Federal Aviation Administration (FAA) as to how many flights an hour may land and take-off. With the increase in inter-national and freight traffic at these airports in recent years, the number of slots available to domestic, especially short-haul carriers, is becoming even more limited. Since most of these slots are controlled by large carriers, it is difficult for other carriers to enter the market (Anderson 1998b). The government (FAA & DOT) has the power to reallocate these spots, but chooses not to do so; even allowing airlines to buy and sell slots as if they were private property. Even in cities with second airports (New York, Chicago, Washington), control of gates at the main airport is a major advantage. Improvements in air traffic control and movement of military, general and corporate aviation to secondary airports has offered a few more slots to airlines. Political pressure from various interest groups has slowed the awarding of new slots. In October of 1998, for example, Congressman Henry Hyde (R. Il.) blocked the addition of between 20 and 100 slots a day being added at O'Hare in response to concerns of his constituents concerning noise at the airport.

>Airport gate leasing restrictions. Most U.S. airports have been built by local government bodies. These agencies often lack the capital to construct such large installations. The practice has been to have the airlines help finance these projects in return for control of a block of gates, or even a terminal. These lease agreements often extend for decades. The existence of these leases can keep new entrants out of airports, or in some cases, consign these smaller carriers to less desirable locations in the terminal (Kearney 1988). Airlines which cannot get a reasonably convenient gate at an airport, operate at a competitive disadvantage.

>Airline alliances & Joint marketing agreements: In recent years, airlines have begun to form alliances. The first of these were the local service carriers which became extensions of the larger carriers (United Express, American Eagle). This was followed by international alliances between major carriers and major foreign carriers. The third form of alliances was domestic, in which major carriers allied with other (usually weaker) major carriers (Anderson 1998c, Gourdin 1998). The nature of the barriers presented by domestic and international alliances are described below.

>Domestic alliances. The older of the two forms of domestic alliances, that between major carriers and local service carriers, has been around long enough to judge the results. These alliances started as a means of offering low cost service in small markets in order to compete with the low cost start-up carriers. The local service carrier would get the advantage of the name recognition, reputation and reservation support services of the larger carrier. The larger carrier would get some revenue from these markets, but, more important, would get the on-line-feed from the smaller carrier. This was important in building strong dominant hubs. The through traffic could be kept on the parent airline through the use of code sharing. By extending frequent flyer mileage to passengers on the smaller carrier, more brand loyalty was built. The dominance that these arrangements helped build reached beyond the hubs to entire regions of the country. Barriers were created against competition in both the long-haul and short-haul markets affected by the arrangements (Anderson 1998b).

> International alliances. The international alliances take the form of code sharing, frequent flyer program merger, schedule coordination and ground service. The purpose of these agreements is not only to reduce competition in international markets (though by the nature of international air commerce agreements, there are usually only two carriers in the international markets), but also to reduce competition in domestic markets (Anderson 1998A). In the agreement between UAL and Lufthansa, a passenger can make a reservation on a flight with a UAL flight number and fly from Des Moines to O'Hare on a United Express flight operated by a small, low-cost airline; transfer at O'Hare to a Lufthansa aircraft; cross the Atlantic and board a Lufthansa short haul flight from Frankfort to Hamburg. The passenger receives UAL Mileage Plus mileage for all three legs, has a single UAL flight number from Des Moines to Hamburg and may never set foot on a UAL aircraft. Lufthansa gets a passenger across the Atlantic and for the short haul in Germany, UAL might get the passenger on the return trip, but gets some revenue from the short haul trips to and from Des Moines. UAL strengthens its hold on O'Hare for Domestic and International traffic.

>Cabotage restrictions. Across the world, with very few exceptions, nations restrict domestic air service to their own airlines. United or American can't carry passengers between Paris and Nice or between Hamburg and Frankfort. In most countries this is not a major issue, in that they have negligible amounts of domestic air travel. The U.S. domestic airline market represents over half the domestic air travel in the world. Foreign carriers have wanted to gain the right to continuation traffic on flights originating outside of the U.S. but serving more than one point in the country. For example, on a flight from Singapore to San Francisco to Chicago, the leg from San Francisco to Chicago would be a domestic leg. United (UAL) or Northwest (NWA) can pick up passengers in San Francisco bound for Chicago. Air Singapore cannot. An Air Singapore flight must travel half empty on the last leg. The U.S. based carrier has an advantage in both the International Market over Air Singapore and in the domestic market over domestic competitors. In addition a landing slot is being used in San Francisco and in Chicago, but no competitive pressure is being put on UAL or NWA.

POLICY RESPONSES TO ANTI-COMPETITIVE BEHAVIORS

The anti-competitive strategies and constructs described above combine to result in an airline market that is not fully contestable. Airline passengers face high prices in some markets due to lack of competition. Entire regions of the country are dependent on individual carriers for service (as can be seen in the recent strike against Northwest Airlines). Policy makers have acted in the past to end, or reduce, abuses of the airline reservation systems. They can act again to secure the advantages of competition for the flying public. While policy makers cannot do much about naturally occurring barriers, and cannot expect to wipe out all other anti-competitive behaviors, there are some things that can increase, or at least reduce the decreasing of, competition. Among those actions are:

>Increase the number of slots available at the busy airports, and allocate them with the intent of increasing competition. This could be done by simply refusing to award new slots to dominant carriers, or by requiring that airlines applying for new slots detail how those slots would be used to increase competition.

>Subject airline mergers to strict scrutiny when those mergers would result in a significant reduction in competition, or require the merging carriers to divest operations that would reduce competition. Any merger that would give the new carrier a dominant position at any major airport, or in major city pairs should be opposed, unless gates, slots, and flight frequencies would be given up to other carriers. Mergers such as TWA-Ozark or Northwest -Republic have been allowed in the past in spite of major reductions in competition and contestability.

>Subject alliances and joint marketing agreements to the same scrutiny to which proposed mergers would be subjected. This should be the case both for domestic and international alliances. Since they behave much like merged carriers, they should be treated like merged carriers.

>Allow continuation cabotage for foreign carriers in markets that are deemed to be uncompetitive. When domestic carriers are not able or willing to challenge dominant carriers in domestic markets, foreign carriers serving one or both of the cities in the city pair should be offered the opportunity. The presence of, or threat of entry of an extra carrier could act to restrain the dominant carrier.

>Restrict the use of commission overrides for travel agents, or at least require travel agents to inform consumers of any override programs in which they participate. Full disclosure would remove some of the moral hazard faced by travel agents to give customers less than the best deal. Smaller carriers would be able to compete on an even basis.

>Increase the number of gates available to smaller carriers at un-competitive airports. It will be difficult to change existing leases, but policy makers can restrict dominant carriers from acquiring new leases when other carriers leave and can pay attention to the interests of non-dominant carriers when planning expansions and renovations to airports.

>Tax that portion of frequent flyer awards stemming from business travel, paid for by the business. If business travelers receive benefits from travel for which their employers have paid they should be taxed on those benefits as regular income. If business travelers had to pay income tax on their personal use of mileage awards, these awards would be less valuable.

>Require airlines to disclose to whomever pays for a ticket, how many frequent flyer miles a passenger received using the ticket. Airlines have resisted disclosure, citing privacy concerns. In reality they are

concerned about theses programs becoming less powerful tools. If employers knew how many miles employees accumulated through business travel, they could require the employee to use the benefits for business travel. This would remove the incentive for the employee to make travel decisions on the basis of mileage, and remove the ability of these programs to shield the airline from competition.

Policy makers should make the increase of competition a priority in the airline industry. There are affirmative policies, well short of a return to onerous regulation, that can make the industry more competitive. Some of them have been outlined here, but there are other actions that can be taken. Deregulation has benefited the consumer, the airlines and the complementary industries. The benefits of deregulation should not be lost to anti-competitive marketing strategies. Policy makers have a duty to act.

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