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ARE LOW COST AIRLINES THE WAY FORWARD FOR MALTESE TOURISM DEVELOPMENT AND TRAVELLING?

Christopher Micallef

Abstract: The international airline market has in recent years been characterised by an introduction of low cost activities, which although not removing the more traditional ones, have resulted in cost savings, increased demand and economic efficiency gains. Onset of this phenomenon in Malta may have been retarded by cost and volume disadvantages. The implementation of recent policy initiatives may be seen to contribute to a more level playing field in the airline industry in Malta, with a potential for enhanced economic efficiency.

1. Introduction

Discussion of low cost airlines has gained prominence in Malta since the summer of 2005 and is still a hot topic on the cards of the tourism industry players and the government. A tourism incentives package unveiled by the government on the 10^{th} April 2006 is operational, with the social partners analysing the impact of these policies on their business, providing policy makers with their input concerning the effect of current policies and directions for the future. Society in general is finding this latest development in air travel fascinating and hopes that the decisions taken will be in the national interest.

Despite the negative trends in the airline industry that have only been recently reversed, low cost airlines have succeeded in increasing their turnover, profit and the number of passengers carried. The interest in the low cost air travel business is expressed in the huge market capitalisation of low cost airlines on the stock market. The success of low cost airlines has induced the emergence of a growing number of such carriers, while other established full service carriers are reacting by trying to compete following various strategies. Low cost airlines manage to stimulate new demand and not only take customers away from traditional carriers, and fly to/from secondary airports availing themselves of very cheap charges and taxes.

2. The Business Model

A low cost carrier, also known as a no-frills or discount airline is one that offers low fares while eliminating most of the traditional services offered to passengers. Usually such services as baggage handling and on-board food are regarded as part of the package being sold and are therefore included in the ticket price. Low cost airlines figured out that customers would accept a simple service as long as cost savings would be passed on to them. The concept originated in North America with Southwest Airlines before spreading to Europe in the early 1990s and subsequently to much of the rest of the world.

Mercer Management Consulting outlined the business design utilised by low cost carriers with three key differences from traditional airlines being; a simple product, low operating costs and aggressive positioning (MMC, 2002). The major innovation was not only the low level of fares but also the availability of such fares on a one-way single basis without any restrictions. Fully flexible travel is possible through simplified pricing structures based on demand-regulated fares or flexible return tickets (Pender & Baum, 2000).

Cost advantages

People travel ticketless in one class and cannot make seat reservations. Food and drinks are not given for free, while narrow seating succeeds in ensuring a higher capacity on each plane. Added value like frequent flyer programs are not available. As low cost carriers offer fares in the region of 50 percent lower than normal scheduled fares, they have to maintain a sustainable cost advantage to survive in the long run. Low cost airlines typically have cost advantages as indicated in Table 1 (**Doganis explains that the assumed reductions in cost are based on observed differences between low cost and traditional airline costs in the UK, using financial and cost data published by the UK Civil Aviation Authority**).

Table 1

Cost advantages of low cost carriers on short-haul routes

	Cost reduction
Operating advantages	
Higher seating density	16%
Higher aircraft utilisation	3%
Lower flight and cabin crew salaries	3%
Use of cheaper secondary airports	6%
Outsourcing maintenance/single aircraft type	2%
Product/service features	
Minimal station costs/outsourced handling	10%
No free in-flight catering	6%
Marketing differences	
No agents commissions	8%
Reduced sales/reservation costs	3%
Other advantages	
Lower administration costs	2%
Total Cost advantage	**59%**

Source: (Doganis, 2001)

Low cost airlines mainly market their product to leisure traffic and price-conscious business passengers. Such airlines specialise in serving short-haul point-to-point traffic with high frequencies, instead of the usual hub and spoke system. Secondary airports are used as these have lower charges and may even subsidise low cost carriers' operations due to their importance to regional tourism and airport revenues. Aggressive marketing is deployed to generate new demand and take away existing demand from other carriers.

Revenue Advantages

Low fare airlines also possess certain revenue advantages. Unlike traditional airlines, low cost companies have a different yield management strategy where ticket prices increase as the departure dates approach (Pender, 2001: 173). Selling directly to the public, these companies generate their cash before delivering the product, facilitating cashflow while generating interest income on their cash deposits (Doganis, 2001). In the case of a no-show by a passenger, the airline still has the money and the passenger cannot change the tickets and fly on another day. The ticket can then be resold to another passenger. Ryanair keeps the airport fares of passengers who do not fly in contrast to traditional airlines, earning around euro45 million in 2002 from no-shows (Ryanair, 2002).

Table 2 shows these same airlines ranked by performance, which is measured in terms of Return on Equity (ROE).[1]

Table 2

Ranking by ROE of major international airlines - Reuters

	Name	Revenue (M)	ROE
	Industry Average	$9,220.3	17.0%
1.	Lan Airlines S.A. (ADR)	$2,506.4	31.3%
2.	British Airways plc (ADR)	$14,372.2	18.0%
3.	Ryanair Holdings plc (ADR)	$1,952.3	16.8%
4.	Deutsche Lufthansa AG (ADR)	$23,016.6	16.1%
5.	Alaska Air Group, Inc.	$2,975.3	11.3%
6.	Southwest Airlines Co.	$7,583.0	9.0%
7.	JetBlue Airways Corporation	$1,701.3	-2.4%
8.	Continental Airlines, Inc.	$11,208.0	-35.7%
9.	AMR Corporation	$20,712.0	NA
10.	Delta Air Lines, Inc.	$15,689.0	NA
11.	KLM Royal Dutch Airlines (USA)	$7,399.6	NA
12.	SkyWest, Inc.	$1,964.0	NA
13.	UAL Corporation	$17,379.0	NA
14.	Northwest Airlines Corporation	$12,124.0	NA
15.	US Airways Group, Inc.	$5,077.0	NA

As of Mar 08, 2006

The point that emerges is that low cost carriers rank considerably high in terms of performance, while not being very large by industrial standards. This attests to the fact that they value performance highly and do not usually decide to grow if it is at the expense of performance.

[1] A measure revealing how much profit a company generates with the money shareholders have invested in it. ROE was preferred as Return on Assets (ROA) varies between companies depending on their respective business model, while Return on Investment (ROI) is subject to valuation problems as considerable care has to be exercised in selecting, classifying and evaluating expenditure items and revenue accruing from any particular investment. This measure is very subjective.

The year 2006 marked a positive turnaround for the global air transport industry, with Director General and CEO of the International Air Transport Industry (IATA) Bisignani, stating "we are starting to see some light at the end of a five year tunnel – some cautious optimism". Cost-cutting, robust economies and rapidly developing markets are driving an improvement in airline profitability. The industry generated $13 billion in operating profits in 2006, more than double the level in the previous year, though still low at just over 3 percent of revenues. Post-tax net losses were down to $500 million from $3.2 billion in 2005. Substantial differences between regions remains, as nearly all of the $42 billion losses accumulated in the past six years have been generated in the US market (IATA Annual Reports; 2006, 2007).

In the decade to 2005, the industry became 54 percent more efficient in its use of labour, 21 percent more efficient in its use of fuel, and 5 percent more efficient in its use of aircraft (IATA Annual Reports; 2006, 2007). These efficiency gains are reflected in the industry's control of unit costs despite inflation in salaries and in the prices of other inputs, not least fuel. Adjusting for currency effects due to the fall in the US dollar, non-fuel unit costs have dropped an estimated 14 percent since 2001.

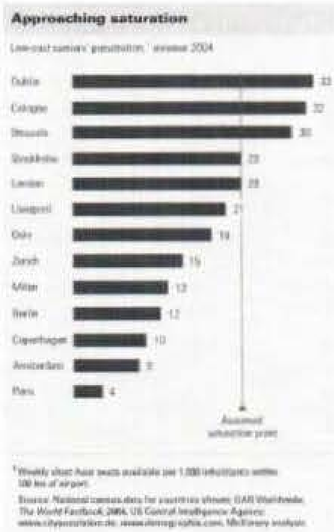
Future Prospects

The traffic in Europe's low cost carrier market increased on average by 37 percent a year from 2001 to 2003. This was mostly driven by the profitable expansion of industry leaders Ryanair and EasyJet as well as a number of new entrants. About fifty airlines in Europe now define themselves as low cost carriers.

Low cost carriers usually stimulate and exploit unexpressed demand for cheap travel, as their entry into a market draws people who would otherwise travel by train or car, if at all. Surveys indicate that up to three quarters of these airlines' passengers are not customers of other traditional airlines. An analysis of some data in Figure 2 shows that the early and fastest phase of growth for low cost carriers is now drawing to a close in key markets. Many Northern European areas that are prime sources of leisure passengers seem to be at or near the saturation point. Low cost airlines have lost market share and even exited the market on other routes, such as London to Bordeaux and Zurich.

Figure 1

Approaching Saturation



Source: Binggeli & Pompeo, 2005

Markets can be stimulated only up to a point, beyond which further price reductions accomplish nothing. Since low cost carriers' fares are already very low in many markets, they cannot expect demand to be elastic at this point. One has to note also that travelling costs include many other items such as ground transport, airport taxes and hotels. The ability of low cost airlines to stimulate demand is weakening, such that further growth must come at the expense of competitors. Three main forms of competition are likely to reduce growth rates.

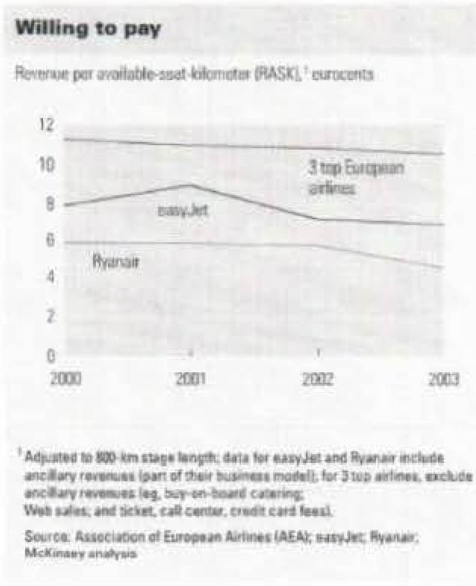
Firstly competition will come from other low cost airlines, as opportunities are exhausted. In the United States for instance, the yield of Southwest Airlines is 15 percent lower on routes where it faces low cost competitors than on routes where it does not.

Secondly, charter airlines have a cost structure that is almost as lean and are increasingly selling airline seats independent of broader holiday packages, taking advantage of the new tourism trend of navigating web sites to self-package vacations. Competition between the two types of airlines is already developing; some 37 percent of their combined capacity out of Germany is now deployed in short-haul, high-volume markets that are served by both.

Thirdly, Europe's traditional scheduled carriers are fighting back. Their unit costs fell by an estimated 15 percent from 2001 to 2003, mainly because they copied some elements of their low cost rivals' business model. Most low cost carriers have not matched this performance. Network carriers are also selling their low cost products by simplifying the design of their web sites, while also persuading some passengers such as business travellers that it is worth paying more for better service and convenience. Europe's three largest network carriers taken together have actually increased their revenue premium over competing low cost carriers, even though their overlapping capacity with these rivals rose from 20 percent in 2000 to 32 percent in 2003. This confirms that the two different types of airlines serve largely different customer segments. **The graph below illustrates the willingness to pay for different airlines, which is derived by utilising the revenue per available-seat-kilometre metric.**

Figure 3:

The willingness to pay



Binggeli & Pompeo, 2005

Overall, the presence of low cost airlines in the markets of the incumbents inevitably lowers their yields and in many cases their revenue per available seat-kilometre (RASK[2]) as shown in Figure 3. This has also happened to low cost airlines themselves, attesting to the fact that competition in low priced tickets has increased. The RASKs of European airlines that have yet to encounter much competition from low cost carriers are expected to fall further. However, the RASK premiums of traditional airlines will probably only erode if low cost carriers successfully build large networks beyond London, with the

[2] This is calculated by dividing Revenues by Available Seat Kilometres (ASK). ASK is equal to the available seats multiplied by the number of kilometres.

attractive destinations, frequent flights, and convenient airports that appeal to business travellers and other high-value customers.

The Economic Impact of Low Cost Airlines

The impact of low cost carriers on fares and passenger traffic has been well documented. Bennett and Craun (1993) examined the impact of low cost carrier Southwest Airlines on a number of California markets. They found that Southwest's entry onto the Oakland-Burbank intra-California route in 1990 resulted in a 55 percent price drop and a sixfold increase in passenger traffic. Windle and Dresner (1995b), using a data set for period 1991 to 1994, found that the entry of Southwest onto a route resulted in an average price decline of 48 percent and a traffic increase of 200 percent.

More significantly, Dresner et al (1996) carried out a general analysis into the impact of low cost airlines on route-specific yields, and on yields of competitive routeings. Results indicate that the presence of a low cost carrier contributed to lower yields and higher traffic levels on the route of entry and on competitive routes. This occurs through arbitrage as consumers search for the lowest priced alternative airports and routes.

Gerardi and Shapiro (2007) conclude that competition erodes the ability of an airline to price discriminate, resulting in reduced overall price dispersion as top end prices fall more than those at the bottom end. This effect is mostly visible on routes having customers with heterogeneous elasticities of demand, i.e. business and leisure travellers.

Morrison et al (2004) developed a structural econometric model of competition in US airline markets to assess how traveller welfare may be affected by the exit of an industry competitor. They found that the market worked sufficiently well by awarding the highest profits to the airlines contributing the greatest welfare to consumers. The market is efficient in determining which airlines remain in the industry such that government financial assistance to carriers would be unwarranted.

3. The Situation in Malta

Traditionally, the main carrier operating from Malta was Airmalta, the national airline, although there were other carriers completing or competing with the services it offered. The business model of Airmalta has over the years developed from one based on the maximisation of political and social rent, with inefficient operations and high prices in a protected market, to one based on an increased exposure to market forces.

Table 3
Malta's airline Market Share Analysis by Airline Type over time

	2005		2006		2007	
Airline Type	**Passenger Movements**	**Share**	**Passenger Movements**	**Share**	**Passenger Movements**	**Share**
Network	2,099,187	77	2,153,835	82	2,237,948	76
Low Cost	136,830	5	244,688	9	449,840	15
Charter	503,609	18	240,049	9	274,957	9
Total	2,739,626	100	2,638,572	100	2,962,745	100

Own calculations using MIA Statistics

Figures shown for airline market share above indicate that market entry for low cost activities up to 2005 was precluded by a number of barriers, mainly of an operating cost and volumes nature, with the Maltese market being in the main characterised by factors similar to those prevailing in the European market prior to the year 2000. An important issue often cited in this respect is the relatively high airport tariffs in Malta (Micallef, 2006). Charter airlines appear to have lost half of their market share mainly to low cost carriers over the three years shown. Studies indicate that it is charter airlines which stand in direct competition with low cost airlines due to their very similar business model (MMC, 2002).

In 2006, the Government of Malta implemented a tourism incentives package involving support schemes to airlines if they operate to specific destinations during the winter and shoulder months, a reduction in tourist operators' and airlines' financial contribution to the Malta Tourism Authority and a more aggressive publicly-funded tourism marketing campaign.

Several low cost airlines responded to the incentives package and are operating from a range of airports including; Ryanair from London Luton, Dublin and Pisa, Meridiana from Bologna, German Wings from Stuttgart and Cologne, and Clickair from Barcelona. Government estimates indicate Ryanair carrying 6,390 one way passengers every month, German Wings carrying 1,700 and Meridiana 980. Incoming tourists stand at around 74 percent of Ryanair passengers, and 70 percent of the other two airline passengers.[3] Official MIA statistics state that Ryanair carried 22,305 passengers during the last two months of 2006.

Meanwhile, AirMalta embarked on a business consolidation and efficiency drive, disposing of a number of ancillary activities including airport retailing and hotel activities with a view to focus on core airline operations. The airline carried 1.86 million passengers during 2006, representing a decrease of 2.4 percent from a year earlier. Competition on the Malta route was very tough with an over supply of seats and very aggressive pricing maintaining downward pressure on yields. An operating loss of Lm6.4

[3] Response to Parliamentary Questions; No. 24088, No. 24927 by Minister Francis Zammit Dimech. The figures shown are government estimates 09/04/2007.

million was made in 2006, compared to a loss of Lm5.7 million in 2005. Higher fuel costs of Lm5 million mainly impacted operating results. Efficiency gains were made as non-fuel unit costs during the year were 9 percent lower than what was expected two years ago. This resulted most notably from maintenance cost savings of Lm3.4 million in 2006 from the comparable period of 2005, with the rollover of the new fleet, payroll costs were down by 5.6 percent and further savings were registered on outstation expenditures. Given the continued increase in the cost of fuel and low cost airline competition, further cost savings will be required (AirMalta Annual Report 2006).

In May 2007, the Maltese Government issued a new call for airline proposals in a bid to expand Malta's air links with European destinations. The call was aimed at the linking of MIA with any airport in the following destinations; the Iberian Peninsula, Sweden, Norway, Denmark, Finland, Bari (Italy) and Bremen (Germany). The scheme has been approved by the European Commission and will provide for start-up costs, specific route marketing and promotion of the route. The amount granted to an airline shall be calculated per passenger embarking from the non-Malta airport and landing directly in Malta with no stop over. Requested financing must be degressive on the basis of the number of passengers achieved and will be granted for a maximum period of five years, which in any event must be substantially less than the period during which the airline undertakes to operate from the airport in question. Payment will be made on the basis of performance, with no payment being made if the airline carries less than 50 percent of the stipulated volumes.

Overall, while this approach may have been criticised in terms of its relatively late timing and insufficient extent, it appears that it is being successful at introducing a more level playing field for operators, thereby encouraging competition, the attainment of efficiencies, and hence, lower travelling costs for consumers. It is however too early at this stage to conduct specific economic assessments on the costs and benefits of these policies, although prima facie indicators point to the reaping of economic efficiency gains similar to those which have happened internationally following the introduction of low cost activities.

5. Conclusions

Low cost airlines adopt a business model focussed on cost efficiency with the main strategy being to offer the lowest possible ticket prices. These airlines have revolutionised the air travel industry, increasing the range of price-quality options available to the consumer whilst spurring other airline types to improve their cost efficiency and decrease ticket prices. Internationally, the existence of low cost carriers is not coincidental and their future is not in doubt, since it is based on satisfying evolving trends in customer demands whilst ensuring lowest possible costs. Other airline types are not collectively in danger of being squeezed out of the market. Competition theory states that as a market becomes more competitive, allocative and cost efficiency improve as firms respond faster to changes in demand which create changes in profit.

The Maltese air travel industry structure was up to 2005, very similar to that observed in Europe before the low cost revolution ensued, revealing the presence of barriers to entry impeding eventual market correction. The wider entrance of low cost airlines following the implementation of a tourism subsidy scheme by Government is not expected to annihilate all the other airlines.

AirMalta is making significant improvements. It is expected that the national carrier will continue to respond to market forces by lowering costs further and seeking new opportunities for revenue growth. Government's tourism incentives package is generating airline interest, and policy initiatives in this respect should continue to be geared towards ensuring that airlines compete on a level playing field.

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