

A Porter's five-force analysis of the airline industry

Like many other industries in 2008, the airline industry is under threat from a variety of sources. Increasing oil prices, the credit crunch and environmental concerns are just three of the issues which are having a dramatic effect on the industry. How will these affect the industry? This case study uses Porter's five-forces model to analyse this.

Current competition

There are hundreds of airlines in the world. Some are very big like British Airways and American Airways and some are smaller like the low-cost airlines Ryanair and easyJet. The rising price of oil is having a dramatic effect on market structure. In the year up to September 2008, 26 airlines had gone out of business. Rising fuel prices impact more on the smaller airlines as they typically operate older aircraft which are less fuel efficient. More casualties are expected by the end of 2008, especially among the 70 smaller airlines operating in Europe.

The credit crunch is also having an effect: IATA estimates that in 2008 global passenger capacity grew faster than the demand for seats. Even national flag carriers are having problems; at the time of writing it is not clear whether the attempts to save Alitalia will be successful. Problems faced by holiday companies also impact on the airline industry. The collapse of XL Leisure Group in 2008 left 85 000 holidaymakers stranded and a further 200 000 without a holiday. One way in which airlines try to protect themselves and provide 'seamless travel' to their customers is through the formation of strategic alliances. There are three main alliances.

The Open Skies agreement has opened the door to possible strategic alliances between airlines and one was under consideration at the end of 2008 – between American Airlines, British Airways and Iberia. This has been heralded as the advent of the global mega-alliance.

Power of buyers

There are two main reasons for air travel – leisure and business. It is estimated that business travel accounts for around 15 per cent of air travel and leisure 85 per cent. Over the last 50 years the demand for air travel has increased greatly. Demographic factors, including

Table 15.12 Major airline alliances, 2008

Oneworld Alliance	Aer Lingus, American Airlines, British Airways, Cathay Pacific, Finnair, Iberia, Japan Airlines, LAN, Malév, Royal Jordanian, Qantas
Star Alliance	Air Canada, Air China, Air New Zealand, ANA, Asian Airlines, Austrian Airlines, BMI, LOT Polish Airlines, Lufthansa, Scandinavian Airlines, Shanghai Airlines, Singapore Airlines, South African Airlines, Spanair, TAP Portugal, Thai Airways International, United Airlines, US Airways
Sky Team	Aeroflot, Aeromexico, Air France, Alitalia, China Southern, Continental Airlines, CSA Czech Airlines, Delta Airlines, KLM, Korean Air, Northwest Airlines

increased life expectancy and better health, have meant that all ages travel more than before. The average growth rate in air travel over the last 20 years is around 5 per cent per annum.¹⁰ Both travel for leisure and travel for business are cyclical and will depend upon economic growth and this demand is highly susceptible to external forces. There was a sharp drop in air travel after 11 September 2001, for example (see Chapter 1), and the effects of the credit crunch will be felt on the volume of air travel. It is generally believed that the demand for leisure travel is price elastic: as prices go down travel increases sharply (and vice versa). It is also generally believed that business travel is price inelastic, that business travellers are less concerned about what they pay as someone else picks up the bill (this is questionable given the extent to which the low-cost, no-frills airlines have expanded in the business market).

The annual growth rate in the numbers of passengers carried has fallen from 12 per cent in 2004 to 5 per cent in 2007. Table 15.13 shows the breakdown of air travel by area and predicted growth rates up to 2011, and it can be seen that these are variable. There has been faster growth in the developing countries, especially China.

Table 15.13 Air traffic by area

Area	Percentage of global air traffic in 2007	Growth rate forecast 2007–2011
Europe	40	+5.0
Asia/Pacific	28	+5.9
North America	17	+4.2
Middle East	7	+6.8
Latin America	4	+4.4
Africa	3	+5.6

Source: Adapted from IATA, 2008.

Another issue which might impact on the level of demand for air travel is the environmental impact of flying. The International Civil Aviation Organisation has a carbon emission calculator on its website. The UK government has announced that it will introduce a new tax which will replace the current air-passenger duty in 2009. The new tax will be much higher than the current tax and it is argued that it represents a more realistic assessment of the environmental costs of air travel.

Power of suppliers

There are two main organisations which dominate the supply of aircraft to airlines – Boeing Company (US based) and Airbus SAS (European based). Both companies have full order books but are experiencing delays in production. Airbus has delayed deliveries of its A380 because of wiring problems and Boeing is experiencing ongoing industrial action by employees. Another supplier of importance is the oil industry – oil represents a third of the operating costs of the airlines. Because of rises in the oil price, the price of jet fuel rose by 80 per cent between 2007 and 2008.

Threat of new entry

The threat of new entry is low because the airline business carries very high fixed costs – there are the costs of purchasing and maintaining the aeroplanes and the cost of landing at airports. All of these are fixed costs which do not change if an aircraft is half-empty. Airspace was deregulated in the 1970s in the USA and in the 1990s in Europe, such that any qualified airline can fly anywhere in the EU without government agreement.

This increased the level of competition and allowed the smaller low-cost airlines to establish themselves. The Open Skies agreement has also reduced barriers to entry for competition by existing airlines if not by new companies. In order to fly, airlines have to pay airport charges and these are very high especially in the bigger airports (this is why the low-cost airlines often operate to and from smaller, less well known airports) and this may be prohibitive. The problems with Terminal 5 at Heathrow in 2008 led to delays in the transfer of BA flights to the new terminal and a backlog of airlines waiting to take up BA's empty slots.

Threat of substitutes

For international travel there is really no substantial competition to air travel; sea travel accounted for only 10 per cent of international trips in 2007. Domestically, the airlines are in competition with all other sorts of travel and there is evidence from the UK that between 2003 and 2007, the fastest growing mode of transport for domestic destinations was railways (up from 6.2 per cent to 7.1 per cent). This growth took place at the expense of road travel rather than air travel, which remained static. Europe has been opened up as a destination for railway travel with the opening of the Channel Tunnel.

The low-cost airlines are cheaper than other methods of travel and of course much faster. The fact that in Europe countries are joined and the rail network is more developed may in part explain why the low-cost airlines do not yet have much of the market (5 per cent) compared with the UK (20 per cent) and the USA (22 per cent).

The Future

The airline industry is experiencing a period of rapid structural change for a number of reasons, which have been considered above. It is argued by many commentators that this restructuring is necessary and that the industry that emerges will be much stronger.

Case study questions

- 1 Why is there unlikely to be a price war between the low-cost providers in the airline industry?
- 2 What might be the effect on the industry of the proposed strategic alliance between British Airways, American Airlines and Iberia mentioned in the text?



For further details see e.g. www.iata.org; www.icao.org; www.oneworld.com; www.staralliance.com; www.skyteam.com