Barriers to entry in the Low Cost Airlines sector

Anthea Paelo

Centre for Competition, Regulation and Economic Development (CCRED)

Economic Research Advisory Network (ERAN) First Annual Conference
10-11 March 2016
East London
Contents

- Introduction and background
- Methodology
- Competition dynamics
- Benefits of competition in South Africa's airline industry
- Barriers to entry and growth
- Conclusions and Recommendations
Introduction and background

- Barriers to entry and inclusive growth – a research agenda. This paper draws from a recent study carried out by CCRED on the behalf of the National Treasury of South Africa.
- The study locates itself in the ongoing national debate regarding transformation and development of the black industrialist programme.
- Barriers to entry create and maintain the market power of large firms, lead to high prices, less efficient economy, limits transformation (Church and Ware, 2000)
- The South African airline industry has seen the entry of a number of airlines since its deregulation in 1991.
- Of the 11 private airlines that entered South Africa’s domestic market between 1991 and 2012, only one is still operation.
- Between 2014 and 2015, 4 new low cost carriers entered the market.
- 1 already suspended after only approximately 10 months in operation.
- There are certain barriers to entry and expansion that contribute to the continued exit of airlines.
- While there are a number of barriers, this paper focused on understanding the strategic barriers to entry in the industry.
Methodology

- Review of competition cases and regulatory framework (*SAA I*, *SAA II* and *U.S. V. American Airlines* (1999)).
- Review of existing literature and data
- Interviews with:
  - Low cost carriers e.g. FlySafair, Fly Blue Crane, 1Time e.t.c.
  - Industry association
  - Consultants in the field
Competition dynamics

• In South Africa’s domestic market, SAA is the dominant firm in SA’s domestic market with 56% market share (SAA, SA Express, Airlink and Mango). British Airways (BA & Kulula) has 35% while new entrants FlySafair and Skywise have 6% and 2% respectively (CAPA, 2015).

• SAA has strategic relationships with 3 airlines; Mango, SA Express and Airlink.

• The airline industry is prone to cases of abuse of dominance.

• The airline industry tends to protect incumbent state carriers allowing them to take part in anti-competitive conduct that restrict the ability of rivals to effectively compete such as raising costs or reducing profits. To this effect, there have been a number of cases.

• U.S. v American Airlines (1999). Anti-competitive conduct evidenced by airline aggressively matching prices, increasing capacity on routes with entry and ability to recoup losses following exit of entrant.

• Air Canada (2001). Test was to show that Air Canada operated below avoidable costs by matching prices set by entrants and increasing capacity on routes.

• A number of abuse of dominance and cartel cases in SA e.g. SAA I, SAA II, Cartel cases (Fuel surcharges 20/CR/Mar05, Code-sharing 43/CR/May06 and Price 42/CR/Apr10)
Barriers to sustained entry

- The airline industry has a number of structural barriers, primary of which are high cost of entry, high operational costs and legal barriers. While substantive, these do not seem to discourage entry and for the most part can be overcome.

- The more significant barriers to entry appear to be related to relationships SAA as the dominant player, has with other smaller airlines on secondary routes as well as its access to state funds and support.

  - **Exclusionary conduct**
    - *Media 24 and Natal Witness* - dominant party enter a subsidiary market with the express purpose of limiting competition as with Mango’s entry.
    - Leverage relationships with other airlines to effect its dominance in other domestic routes in which it does not normally operate e.g. Pietermaritzburg using Airlink and George using Mango.
    - Able to match prices of LCCs even whilst providing more frills (Could be operating below average variable costs. Difficult to tell due to lack of financial statements).
    - Increased capacity. SAA acquired new aircrafts and donated or leased old aircrafts to Mango.

    - Considering SAA’s history of anti-competitive conduct, predatory pricing is likely to be taking place.

  - **Government guarantees and bailouts**
    - May facilitate SAA and associates’ ability to match entrants’ prices despite sustaining substantial losses.
    - Distort market by rewarding inefficiency (Mncube, 2014)
Benefits of competition in South Africa’s airline industry

Percentage price changes on domestic routes, 2014 to 2015 (January and February, respectively)

<table>
<thead>
<tr>
<th>Origin</th>
<th>Destination</th>
<th>% Change</th>
<th>FlySafair entry route</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cape Town</td>
<td>George</td>
<td>-38.8</td>
<td>Y</td>
</tr>
<tr>
<td>Cape Town</td>
<td>Port Elizabeth</td>
<td>-38.1</td>
<td>Y</td>
</tr>
<tr>
<td>George</td>
<td>Cape Town</td>
<td>-37.1</td>
<td>Y</td>
</tr>
<tr>
<td>Port Elizabeth</td>
<td>Cape Town</td>
<td>-32.6</td>
<td>Y</td>
</tr>
<tr>
<td>Port Elizabeth</td>
<td>Johannesburg</td>
<td>-27.9</td>
<td>Y</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>Port Elizabeth</td>
<td>-27.8</td>
<td>Y</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>Cape Town</td>
<td>-17.8</td>
<td>Y</td>
</tr>
<tr>
<td>Cape Town</td>
<td>Johannesburg</td>
<td>-16.4</td>
<td>Y</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>George</td>
<td>-12.9</td>
<td>Y</td>
</tr>
<tr>
<td>George</td>
<td>Johannesburg</td>
<td>-10.5</td>
<td>Y</td>
</tr>
<tr>
<td>Durban</td>
<td>Cape Town</td>
<td>-5.7</td>
<td>N</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>Durban</td>
<td>-2.9</td>
<td>N</td>
</tr>
<tr>
<td>Cape Town</td>
<td>Durban</td>
<td>-1.5</td>
<td>N</td>
</tr>
<tr>
<td>Durban</td>
<td>Johannesburg</td>
<td>-0.6</td>
<td>N</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>East London</td>
<td>1.8</td>
<td>N</td>
</tr>
<tr>
<td>Johannesburg</td>
<td>Bloemfontein</td>
<td>2.7</td>
<td>N</td>
</tr>
<tr>
<td>East London</td>
<td>Johannesburg</td>
<td>3.9</td>
<td>N</td>
</tr>
<tr>
<td>Bloemfontein</td>
<td>Johannesburg</td>
<td>7.4</td>
<td>N</td>
</tr>
</tbody>
</table>
Total passengers for scheduled domestic flights in South Africa, 2011-2015

<table>
<thead>
<tr>
<th>Year</th>
<th>Passenger Traffic (millions)</th>
<th>Percentage Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>24.8</td>
<td>3.2%</td>
</tr>
<tr>
<td>2012</td>
<td>24.7</td>
<td>2.2%</td>
</tr>
<tr>
<td>2013</td>
<td>23.5</td>
<td>2.2%</td>
</tr>
<tr>
<td>2014</td>
<td>23.4</td>
<td>1.5%</td>
</tr>
<tr>
<td>2015</td>
<td>25.2</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

Key Events:
- ITime and Velvet Air cease operations
- Entry of FlySafair
- Entry of Skywise, Fly Blue Crane & Fly Go Air

Entry into the market of these airlines may have contributed to the growth in passenger traffic.
Conclusions and recommendations

- Entry has contributed to desirable effects of lower prices, increased passenger traffic and increase in number of tourists.
- Subsidies to SAA appear to have contributed to
  - Reduced competition and increased prices
  - Reduced passenger traffic and stifled tourism industry e.g. George and East London
- Policy considerations should be focused on encouraging entry rather than only support to SAA.
- Provision of loans to entrants, workshops on cash flow management etc.
- Re-evaluation of extent of relationships between SAA, Mango, SA Express and Airlink.
Centre for Competition, Regulation and Economic Development (CCRED)

www.competition.org.za
antheap@uj.ac.za