AEM 2601: Reading Questions 04 – Best Answers

1. **In a market where Firm A and Firm B are leading suppliers, if Firm A initiates a price cut, the likelihood that Firm B responds with an identical price cut will be greater:**

    - If Firm B's medium term goal is to maximize market share.

2. **Pick one of Porter's Five Forces and briefly describe whether it is favorable or unfavorable in the Airline Industry in 2012.**

    - Competitive rivalry is a very strong, negative force in the Airline Industry. When the airline industry was highly regulated, prices and routes were set so that airlines could be profitable, thus there was virtually no competition. Since the deregulation of the airline industry in 1978, new entrants swarmed looking to make a profit. Since all of these companies offer a fairly identical service, price competition has been their main source of differentiation. Recently airlines have begun competing with branding and rewards systems such as frequent flyer miles, but price competition is still a huge threat to the industry, driving profitability way down.
    - The bargaining power of buyers was unfavorable in the Airline Industry in 2012. With the emergence of advanced technology, the buyers had high bargaining power which has led to low profitability and price cutting in the Airline Industry. There have been numerous online resources that help customers find the cheapest flights like Expedia and Kayak. As a result, there have been price wars within airlines in the industry. There is also very low switching costs amongst airlines because consumers care more about cost and availability rather than the brand, as long as it is established and safe enough. Consumers prefer time, seat, and price more than brand. This in turn has led airlines to keep prices low, leading to low profitability. As the article puts it, essentially, "the changes in the distribution of airline tickets contributed to increased price competition."
    - In 2012, the airline industry experienced soaring fuel price; in consequence, many airline firms raised ticket prices. This phenomenon reflects the power of suppliers -- one of Porter's Five Forces. Fuel is a significant necessity for the airline industry since it is needed to operate the airplanes, and there are no substitutes for fuel. Thus, the airline industry as a whole had no choice to raise the ticket price in order to meet the high fuel cost. Because the fuel companies had significant power as a supplier for the airline industry, the airline industry went through unfavorable experiences in 2012.
    - One of Porter's Five Forces that is favorable to Airline companies already in the industry is the threat of new entrants. There are many barriers to entry that make it hard for new airline companies to become established. For example, they have to get certifications, access to landing pads and gates at airports, create a timely schedule that flies to multiple places, and much more. In addition, many

consumers prefer to fly airlines that they have heard of before because they are trusting their life with the airline. Therefore, it can be hard to convince consumers to fly a new airline and hard to convince airports to allow a new airline since the airport knows customers will be hesitant to use the new company. All of these barriers to entry explain why there is a low threat of new entrants in the airline industry.

3. **Describe one strategy used by airlines to moderate the forces of competition (either to shape the Five Forces, or to be successful despite them).**

- Creating airline alliances like Star Alliance and Oneworld makes it harder for new entrants to compete in the firm because of the existing alliance that is so big. This is a strategy used by airlines to create barriers to entry and keep all profits internal to the industry.
- As mentioned, there is high capital involved in sustaining an airline company. Among the costs are "high, volatile fuel prices that encouraged the airlines to hedge using options and futures contacts and make forward contacts." To lower the airline's input costs and thereby achieve an increased profit within the difficult market, in 2011, Delta Airlines decided to become an active trader in jet fuel and crude oil. Delta also purchased oil refineries to cut down jet fuel bills even further. At a point, 80% of Delta's US fuel needs were supplied internally. Therefore, to bypass the economic disadvantages of supplier power, and to gain a competitive edge over rivals in the industry, Delta capitalized on backwards integration.
- One tactic used to moderate the forces of competition in the airline industry is the hub and spoke system, as opposed to point-to-point operations. In a hub and spoke model, large airlines concentrate their routes on a few major airports linked by frequent services with large planes. Smaller, nearby airports are connected to these hubs with smaller planes. This system allows for greater efficiency and throughput as the incoming short-haul arrivals are concentrated at particular times to be pooled into the longer haul flights. This has allowed major carriers to gain market share and be dominant in regional markets and on particular routes. Also, this has created a barrier to enter the airline industry because new entrants have a hard time obtaining gates at major hub airports. This tactic both shapes the Five Forces by creating a barrier to entry and allows airlines to be successful despite them by increasing efficiency.
- To address the threat of new entrants and the dangers of lowering prices that such a threat may lead to, airlines embraced a more complex price structure. Through price discrimination, airlines sought to capture as much consumer surplus at they could. Larger firms offered lower prices on routes where they faced competition but charged higher prices to price-inelastic business travelers. By capturing more of this surplus, firms sought to avoid the lower profits that would result from lowering fares to all consumers. This was done in attempts to be successful despite the unfavorable threat of new entrants.

- One strategy that many airlines use to moderate the forces of competition is frequent flyer miles. Airlines provide rewards, free flights, or free upgrades to customers who have flown a certain number of miles on their airline. This draws in returning customers who may otherwise have chosen a substitute airline. Since there is not much differentiation between different airlines, frequent flyer miles is how airlines can make themselves more appealing to certain customers, even when another airline sometimes has lower costs. And with all of the potential awards that frequent flyer memberships offer, customers are much more likely to want to take advantage of these awards and repeatedly choose the same airline. This is how frequent flyer memberships can shape the five Forces by limiting the threat of substitutes.