

Logistics and transport  
BE303E 003

**Peculiarities of development of the low-cost airlines  
in Russian and Norwegian context**

by  
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Spring, 2007

## ABSTRACT

Low-cost flights per se become more and more popular in the world airline industry, while in Russia the first low-cost carrier has recently appeared. The purpose of this paper is to investigate the phenomenon of low-cost carriers, peculiarities of the development of the low-cost airlines in the context of Russian Federation and Norway. In order to cover the topic, deep literature review and qualitative research were carried out.

In the paper, I attempted to follow history, analyze reasons for low-cost flights, advantages and disadvantages of low-cost carriers, scrutinize perspectives and peculiarities of the low-cost airline market in Russia and Norway, and analyze future opportunities. Under these circumstances, case study method and interviews as primary information sources and reports and articles written by airline experts as secondary sources were used. Two companies were under the research: *Sky Express* – a Russian low-cost airline company launched the market this year, and a Norwegian low-cost airline company, a member of European Low Fares Airline Association, *Norwegian Air Shuttle*.

Deep literature review concerning low-cost airlines and empirical findings showed that the phenomenon of low fares has its peculiarities on a particular market. In order to understand the role of context regarding the research question, I tried to find similarities and to reveal differences in the activities of two companies with the help of PESTE analysis. Discussing perspectives of low-costs airlines in Russia and Norway, there are particular trends in each case. It is expected increased competition, quality and types of services on the Russian market.

The research confirmed importance and relevance of this topic. It proved that there are not only economical conditions for establishing low-cost airline company but social, technical and environmental aspects which should be taken into consideration when managing low-cost operations. The analysis of data collected by in-depth interviews contributes to better understanding of peculiarities and helped to provide research with the future perspectives on Russian and Norwegian markets. Significant changes and development of the low-cost airline market present wide outlook for future researches.

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## SAMMENDRAG (in Norwegian)

Low-cost fly blir mer og mer populær i verdens flyindustri, mens i Russland har den første low-coster nettopp kommet til livet. Formålet med denne masteroppgaven er å forske fenomenet bak low-cost flyselskaper, særegenheter av utvikling av budsjettflyselskaper i Russland og Norge. For å dekke temaet var det gjennomført kvalitativ undersøkelse og en dyp gjennomgang av litteratur.

I oppgaven prøvde jeg å følge historie, analysere årsaker bak lavpris fly, fordeler og ulemper av low-cost flyselskaper, granske perspektiver og spesialiteter av flymarkedet i Russland og Norge. Under slike omstendigheter brukte jeg case study metode og intervju som primære informasjonskilder, samt rapporter og artikler skrevet av flyeksperter, som sekundære kilder. To flyselskaper deltok i undersøkelsen. *Sky Express* – et russisk lavpris flyselskap som satt i gang sine ruter i 2007 for første gang, og *Norwegian Air Shuttle* – en norsk flyselskap, medlem av European Low Fares Airline Association.

For å forstå kontekstens rolle i sammenheng med undersøkelses problemstilling prøvde jeg å finne likheter og forskjeller i virksomhet av begge to selskapene ved hjelp av en så kalt PESTE analyse.

Undersøkelsen bekreftet viktighet og relevanse av dette temaet. Det visstese at det er ikke bare økonomiske vilkår for etableringen av en low-coster, men også sosiale-, tekniske- og miljøaspekter som skal taes hensyn til ved styring av lavpris virksomhet. Analyse av opplysninger samlet i løpet av grundige intervju bidro til en bedre forståelse av særegenheter og hjalp til å se perspektiver i russisk og norsk marked.

## FOREWORD

This Master Thesis is an obligatory final assignment for the two-year Master of Science in Business (*Master i bedriftsøkonomi*) programme at Bodø Graduate School of Business. The Thesis has the weight of 30 points. The paper is written within the specialization *BE303E 003 Logistics and Transport (Logistikk og Transport)* and is a result of free choice of a problem.

The purpose of this Thesis is to identify and explore phenomenon of low-cost flights based on the study of two particular cases of Russian and Norwegian low-cost airline companies, namely *Sky Express* and *Norwegian* correspondently. This has been done by means of extensive review of secondary data and empirical qualitative study.

I would like to express my gratitude to the project supervisor, Mr. Gisle Solvoll for his help, encouragement, advices and cooperation in the course of work on the Thesis.

A special thank goes to those who found their time to participate in the research and contributed greatly to my Master Thesis by providing with the insights into what management in audit really is. I sincerely thank my interviewees in Russia and Norway: two Managers from *Sky Express* for their keen interest and openness during the interviews, Professor Alexander Bahtin and Professor Siri Strandenes for sharing their profound knowledge and rational advice.

Finally, I would like to thank my daughter Valeria who was born in Bodø three weeks before deadline of delivering my Master Thesis. Thus, I had two great challenges during finishing my studies in Bodø Graduate School of Business.

As author, I take full responsibility for possible errors and deficiencies of this Master Thesis.

Bodø, May 23, 2007

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*Elena Toramanyan*

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## **SURVEY OF ACRONYMS**

LCC – Low-Cost Carrier

LFA – Low-Fares Airline

FSC – Full-Service Carrier

GDS – Global Distribution Systems

ELFAA – European Low Fares Airline Association

## INTRODUCTION

*The purpose of this part is to present general vision of the research background, give clear understanding of the subject, formulate problem statement, highlight limitations and describe the structure of the Master Thesis.*

## BACKGROUND OF THE RESEARCH

The term “low-cost” originated within the airline industry referring to airlines with a low – or lower – operating cost structure than their competitors. Through popular media, the term has to define any carrier with low ticket prices and limited services. I would like to present one comprehensive to my mind definition: “A low-cost carrier or low-cost airline (also known as a no-frills or discount carrier / airline) is an airline that offers generally low fares in exchange for eliminating many traditional passenger services”<sup>1</sup> ([http://en.wikipedia.org/wiki/Low-cost\\_carrier](http://en.wikipedia.org/wiki/Low-cost_carrier)).

The idea of low-cost airlines was born almost 40 years ago, when a Texan lawyer Herb Kelleher decided to make people happy by regular intra-state flights. After a series of drawn out legal battles instigated by incumbent carriers and several years spent getting the license (inasmuch as the Civil Aeronautics Board did not allow to make air transportation within one state), Kelleher created a precedent and in 1973 a new carrier, Southwest Airlines, was set up. The Kelleher’s concept was “Spartan conditions for low prices”. In two years, the airline became profitable and stayed profitable ever since.

Boom of use of low-cost strategies came in the period of 1990s with its rapid spread around the world. It is interesting why just recent times have seen the explosion of low-cost strategies in the airline industry, when the example of Southwest’s success was obvious for many years.

Many researches explain this by several obvious facts (for example Shaw, 2004; Lawton, 2002; Calder, 2002). Regulatory liberalization is the first explanation. The agreement for the setting up of the Single Aviation Market of the European Union in 1993 gave opportunities for new entrants, which never existed before (Shaw, 2004). Internet as a channel for airline distribution is also significant - it led to fast and cost-effective distribution because of simplified process of

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<sup>1</sup> Low-cost airlines and low-fare airlines are often used as synonyms.

reservation procedures. Also changing nature of business air travel market provides an explanation for the growth of low cost strategies (Lawton, 2002). Up until the middle 1990s, business travellers were the main target consumers of airline services who needed prestige and status. Nowadays the air travel market is characterized by the saturation of not only business customers but also leisure travellers who do not need business class on board.

In America and Europe, there exists a developed market of low-cost airlines. Alongside with independent low-cost airlines, such as Ryanair and EasyJet, there appeared low-cost subsidies, such as daughter company Germanwings and its parent Lufthansa. In Russia, this market has just started to develop. At the same time, it is characterized by a number of difficulties and challenges, which the new entrant has to manage, and a number of new potential customers. These facts outline the significance of improvement and development of low-cost model in Russia.

In Russia, low-cost model is quite a new “wave of doing airline business”. Not all companies are ready to cost leader strategy, not all market, technological and other conditions are suited for implementation. However, Russian experts get more and more involved into the idea of low-cost airlines and emphasize such practice as a prospective in Russia.

## **PROBLEM STATEMENT**

In the Master Paper, the research problem is represented in the investigation of the phenomenon of low-cost flights. I shall try to gather up previous researches in this sphere and make my own investigation.

Therefore, based on the highlighted background for the choice of the subject **the problem** I will focus on can be formulated in the following way:

*Peculiarities of the development of the low-cost airlines in Russian and Norwegian context.*

The points, which help me to answer the main problem statement, are:

- To follow the history of low-cost carriers.
- To highlight their advantages and disadvantages.
- To discuss and analyze reasons for low-cost flights.
- To discuss benefits for customers and producers.
- To investigate the choice of low-cost flights by customers: How do they make their choices, what factors dominate? Analysis of theory and European practice.

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- To investigate the choice of low-cost flights by producers: How do they make their choices when setting prices, what factors dominate, is there any trend? Analysis of theory, secondary information and European practice.
  - To describe challenges of providing low-cost flights services in Russia and in Europe based on theory and practice (interviews).
  - To analyze opportunities of Russian market of low-cost carriers through the prism of theoretical approaches (interviews).

The identified problem is quite inspiring for me. Living in a contemporary world and being actually a potential consumer and having had an opportunity to plan flights himself, I think it is interesting and important to understand deeply the existence of low-cost carriers and opportunity of operating them in the Russian market.

## LIMITATIONS OF THE RESEARCH

To prevent possible misunderstanding of formulation of the research question and to narrow the area under my intentions, I would like to stress on the limitations. It is an important issue of the paper, because I should specify some points to make the results more valuable.

According to the complexity of the research question, I make a comparative study on the example of two airline companies. Hence, the first limitation concerns to the *geographical aspect*. In my research, I stop on the Norwegian and Russian airlines companies, during gathering primary information. Such approach provides us with the possibility to consider the problem deeper under research and use local knowledge.

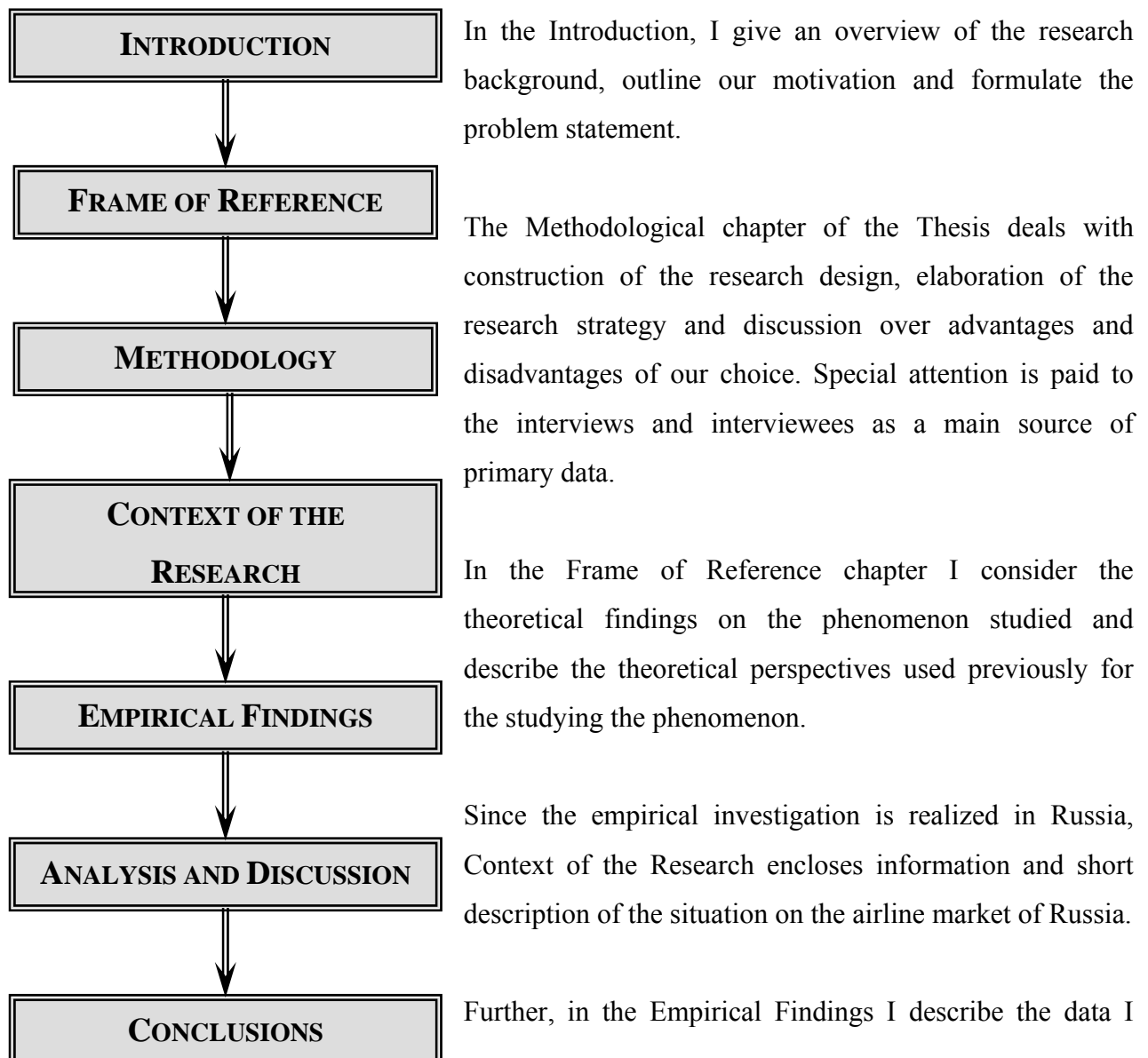
*Number of companies under research.* As mentioned above, geographical, time, finance, a well-known fact that managers prefer not to open their business secrets, are the main points concerning gathering information in the European market. The research question has a very high actuality of on the Russian market as the chosen research question concerns a very “hot” topic. Still the fact that most Russian companies pay very much attention to information protection makes it very difficult to get a comprehensive data about project’s state of play on the current moment. Anyway, my plans are to investigate opinions of the companies’ experts of both sides: one company that wants to be a low-fare carrier on the Russian market and a Norwegian airline, which acquired experience as low-cost operator during a number of years. I believe it is a

reasonable sample in accordance with the requirements of the research and my abilities, since I do my research alone.

Due to mentioned limitations, the paper does not intend to give a complete, complex and multifactor nature of the phenomenon. Nevertheless, I hope that the paper will contribute to better understanding of the local issue.

## DISPOSITION OF THE THESIS

The introductory part of the Master Thesis is followed by the six chapters including frame of reference, methodology, context of the research, empirical findings, analysis and conclusions. The thesis is structured as follows:



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have collected in the framework of the research of low cost airline companies in Russia and Norway, and the data taken from the secondary sources.

The Analytical chapter of the Thesis is devoted to discussion of our findings based on the theoretical framework chosen in order to answer the problem stated in the Introduction.

Finally, the main results, conclusions and suggestions for further research are presented in the Conclusion.

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## METHODOLOGY

*Methodology chapter aims to link both theoretical framework and empirical findings in appropriate way. The present chapter highlights issues of theoretical perspective with its implementation into the research to be carried out during writing Master Thesis. I start with the concept of the research and continue with the research design, which describes and explains types of the research strategy chosen. Then I move to the data collection methods with reasoning the choice, their advantages and disadvantages. Further, I will explain methods of evaluation and interpretation of the data and move to the dependence of validity, reliability and generalizability on the relevant methods of the research. Finally, I will consider the question of ethics.*

### CONCEPT OF THE RESEARCH

Thomas calls concepts “tools of thinking” (Thomas A.B., 2003). Generally, concepts are unproblematic and serve us well. However, sometimes concepts we rely on seem less than satisfactory. Here I stop on the concepts that will serve a better basis to my research.

My investigation is represented in the framework of the concept of the Research Spiral (Hauan, 2005), which show relations between chosen methodology and the aims of the research.

According to the concept, I begin with finding the facts about research question: situation that is presented nowadays, past and future perspectives at the moment when the research was started. In my research, I collect primary and secondary data about history of low-cost carriers, provide interviews. Then, using a methodological approach, I transform these facts into data, which I can structure, analyse, and make it more oriented towards the aims of the research. Afterwards, with the help of analytical methods and number of techniques, the data collected is converted to the information, which is strictly oriented to the research problem and with its help it is possible to answer the research questions or move to another level of question formulation. Hence, the difference between two almost similar meanings, data and information, is that information gives us ability to answer the problems of the paper; it is structured according to our needs whereas data is more disembodied (for example, my notes (records) after interviews are data). To transform them into information I have to structure them, give clear formulation, and make selection of fruitful and rich data for rich information



design. This information we I sum in description of empirical part. Realization and understanding of this information will provide us with a new knowledge about the issue. Knowledge, in its turn, is applied to practice by a set of actions directed to solving an issue. This knowledge in our case is answers for the problems of the Master Paper.

This is the example of one spiral cycle. However, the completion of one cycle initiates beginning of the next research cycle with new facts, giving the basis for new problems and new data. Thus, we can see that the cycles form a spiral where the researcher gradually moves from one level to another, higher one, in the course of work upon the research under consideration.

The graphical presentation of the concept is illustrated in the Figure 1 (adapted from Hauan, 2005).

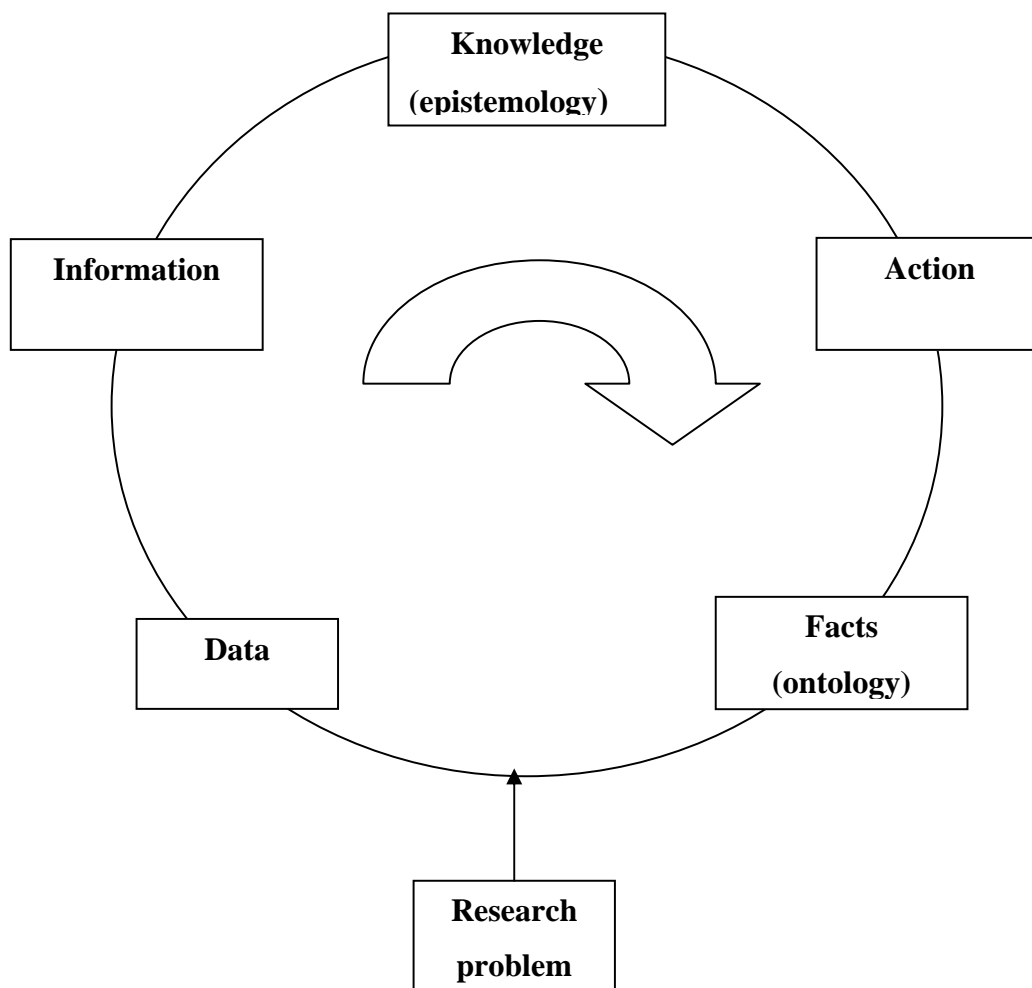


Figure 1. Research Spiral concept (adapted from Hauan 2005)

According to the classification of scientific problems, represented in the Figure 2, my research has an empirical character not conceptual one.

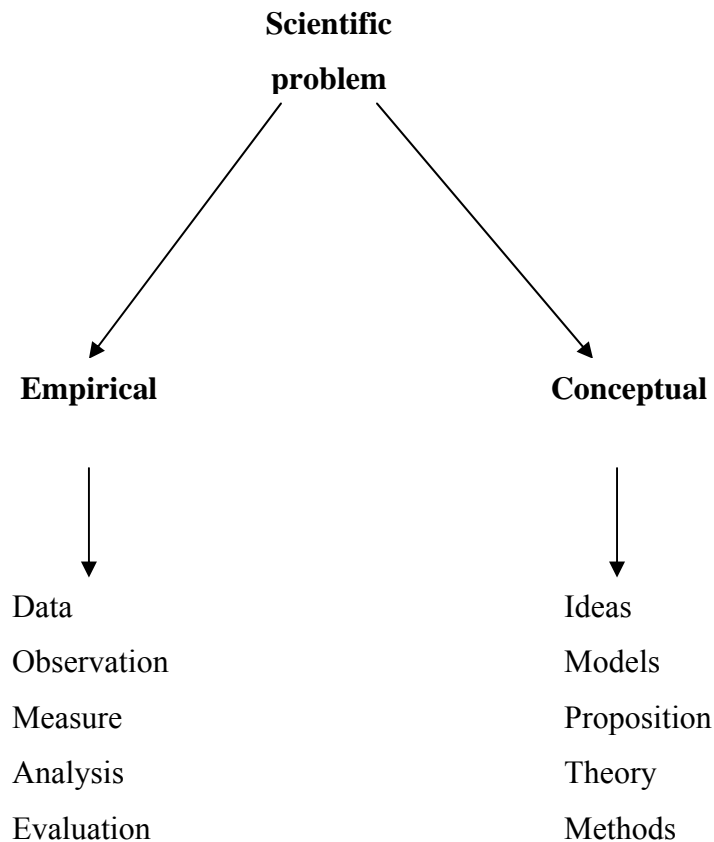


Figure 2. Empirical or conceptual Science problems (Hauan, 2005).

All steps described above (data collection, observation, measure, analysis, evaluation) are implemented in the Master Paper. Analysis and discussion of received data will be the result of my research, not new theories or models.

## RESEARCH DESIGN

Research design by Green and Tull (1975) is ‘specification of methods and procedures for acquiring the information needed to structure or to solve problems’. It is about organizing the research – data collection, analyzing, and interpretation of the results. Here I describe the relationship between data and theory for the certain research; identify the philosophical dimensions that will help to organize the process of data collection and interpretation, choose the methods for the research that will lead to the required aims.

## **Type of research**

If I try to classify the research upon its outcome, as it is usually done to identify the type of research, I devote our research, firstly, to the pure one, as theories of the logistic application will be examined in a certain new set of examples (Russian and Norwegian low-cost flights companies). In addition, my research reflects mostly the idea of an applied research, as it is an investigation of a concrete problem, a case, based upon a consolidated data collection (especially primary data in interviews), application of the theory and seeking for a case solution. Still, I believe that there are in place some features of an applied research as well, because the research can be treated as an evaluation of implementing of the process and results of introduction the international low-cost practice in Russia.

## **Research paradigm**

As a researcher, should I take a position of positivist, social constructionist or relativist? The philosophical paradigms always underline practical research, each of them has its strengths and weaknesses, but the correct choice of the paradigm helps the researcher to choose methods for the research and identify general approach to the research design, data collection and interpretation.

Positivists focus on facts, causality and fundamental laws through formulating hypotheses and testing them. Thus, positivist position states broadly upon the quantitative methods and data types, it engages wide range of both amounts and sources of data and the ways and tools for its interpretation. However, at the same time it is general, inflexible and outside. It helps to understand what was and what is, but does not give a basis for evaluation or prediction, for linking to theories, for interpretation human actions.

Relativist position requires mostly very general researches with the use of multiple sources of data, with wide conclusions and opening new perspectives, with consideration of several countries and examples.

Therefore, for the research here I choose social constructionist position in order to avoid both concentration only on quantitative details of the problem and going too broad far away from the certain example. I do not have large amounts of quantitative data, though I anyway use it, collect it and analyze. One of the central tasks for the paper is to understand and interpret

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(especially primary data) according to the existing theories given situation in the certain problem of the low cost flights in Norway and Russia; to evaluate the results.

## **Choice of Research Strategy**

Now, basing upon the outlined steps of the research strategy choice I link my concrete strategic research moves with philosophical foundations that I stated before.

### *Independence or involvement of the researcher*

I am not conducting an action research, usually described as being fully involved in the process, thus influencing the research and providing subjective interpretation. Therefore, to the degree of involvement in the research I can call it a cooperative inquiry, for I focus on personal actions, feelings, perceptions of the managers, I make them work to answer my questions and reveal required problems. This is feasible under the social constructionist position.

### *Large or small samples*

Upon the social constructionist approach, I cannot use large samples, as those mostly are provided for the positivistic researches. While my study uses both quantitative and qualitative secondary data and qualitative primary data and bases upon the example of a certain companies in certain countries – it investigates descriptive questions by the use of interviews. This follows the definition of a case study.

### *Theory or data first*

The idea of pre-understanding is important for the interviews, to prepare, design correctly interviews I need a thorough work with the theory and secondary data sources, acquiring knowledge on the phenomena in general, on the opportunities and perspective in Russia today, on the experience of European markets. Only this way it will lead to a successful data gathering during the interviews and the following process of its interpretation. In addition, upon the social constructionist position of the grounded theory, when ideas come from the data first collected, the researcher should be mostly open for the new knowledge and directions of the thoughts after interviews, reflections and investigations upon the data collected and theory after applied. The cycle of interpretations and understanding - the hermeneutic cycle is the process by which we return to a text or to the word and derive a new interpretation every time, for every interpreter (Ross, 2004).

*Experimental design or fieldwork*

Case study is a fieldwork method; it contains investigation of a certain phenomenon within a real life context and implication of both quantitative and qualitative methods of data collection and interpretation. As the providing of low-cost flights service in Russia has just begun, the phenomena under research is really a complex one and one of the primary aims of the research is to gain some knowledge and understanding of the situation, so case study method states best for the research design.

*Universal theory or local knowledge*

Social constructionist position claims that the theory should be understood in the context, and not universally. That the approach I will choose for the research for investigation of a Russian and a European company.

*Verification / falsification*

This issue is not under consideration in my paper, as I do not use positivistic approach. Moreover, as the main purpose of the research is to acquire knowledge, I do not have any theory to verify or falsify.

The steps of the research strategy choice proved the choice of the philosophical basis of the social constructionism being adequate for the research with the use of both quantitative and qualitative methods, secondary and primary sources of data, “why” questions case study of Russian and Norwegian low-cost airlines companies.

**DATA COLLECTION METHODS**

Quantitative methods framed within the positivistic position assume a clear certain research of a certain numbers and certain places with the usage of certain statistical limitations and tools, otherwise they would lead to bias and thus failure of the research.

Qualitative methods are much less strict, so much more flexible. They propose a kind of iterative process, which presuppose when some analysis takes place during the process of data collection (it is convenient at interviews to check new ideas that appear).

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As is in the reality by definition both methods go often together in practice, thus will be conducted in my research as the statement of the research problem and research questions anticipates both types of methods in use: quantitative data to follow the history of low-cost flights and prepare for primary data collection in interviews, and qualitative for further data collection and analysis during the interviews and discussion of the questions of reasons, advantages and disadvantages, benefits for different kinds perspectives – opportunities and challenges. This choice of methods also accords with chosen for my research social constructionist position.

## Secondary Data

Secondary data is information, which already exists and is accessible, like statistics, reports, and previous research results. Typical examples are public statistics, government and consulting reports, publicly available reports from such private groups as foundations, publishers, trade associations, unions, articles in trade magazines and newspapers, business newsletters, and other accounts that are at least one step removed from the initial data source by the researcher or some other “filter” (Aaker and Day, 1990). In addition, internal sources are regarded as secondary data: sales reports, budgets, and reports from business travels, trade fairs (Naslund, 2002).

In the research, I use various kinds of secondary data. Internet, statistical information gives a good ground to make an analysis of trends of price change on different flights. Various articles in magazines and electronic articles help to understand consumers’ opinion about low-cost carriers’ service and their attitude; also, it can give a light to producers’ reasons and intentions towards policy of low prices. Russian newspapers, such as “Expert”, “Kommersant”, “Business week”, give, for instance, an overview of the situation on the Russian market, opinions of the specialists upon the question we investigate in our research<sup>2</sup>.

At the initial step, I visited several libraries in Bodø and St. Petersburg to look through recent published materials on the issue. Equally with published and internet articles as the main sources of the secondary data, I follow mass media materials on the issue, such as radio and TV news.

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<sup>2</sup>See for example Business week, December 27, 2006

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The experts; points of view on the topic were worked out from their consulting reports, on-line interviews and articles.

We should pay special attention to the “Norwegian” and “SkyExpress” homepages as the most valuable electronic sources of the data. In addition, the independent researches of European Low Fares Airline Association are of great importance in my investigation, as well as some professional researches of different Universities.

I believe using the secondary data will make the research less time-consuming and richer from the information viewpoint. Though, since secondary data is all the 'rest' data but the one intentionally collected for the purposes of the research, I should adhere to rather strict filtration of the data dealt with the object to obey relevance, timeliness and the chosen focus.

### **Primary Data**

The primary data is the data, collected by the researcher himself. When it is not enough of secondary information to solve the problem or answer the research question, the researcher needs to gather data by using special techniques (Easterby-Smith et al., 2002). Researcher collects primary data by using one or another data collection technique. According to Riley et al. (2000) the range of primary data collection methods includes social surveys (questionnaires), structured interviews, unstructured interviews, focus groups, observations, participant observations and others, the items listed according to the level of personal involvement of the researcher starting from the lower, and according to the size of respondent group starting from the larger. The advantage of primary data is that it is tailored for particular research and therefore more reliable. The disadvantage is that primary data collection can be very costly and time-consuming.

In my work, I try to use the most appropriate methods in the case. Participation observation is hardly appropriate in my situation at least considering the time limits that I face. On the other hand, social survey is not quite appropriate for me because either I am not aiming at operationalisation of the categories related to the question under consideration, but more likely at understanding, with an opportunity to change the questions asked with new information gained. Hence, I choose interviews as a main method of collecting primary data.

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*Interview and interview conditions*

The empirical part of the research on “company-level” was realized mostly due to holding two in-depth interviews. This will be done in order to understand the phenomenon looking by experts at it from two perspectives, from European and Russian, and to increase the understanding of the phenomena identified in the previous studies.

Easterby-Smith et al. (2002) claims that the interviewing is “the best” method of gathering information. According to the social constructionist paradigm, we elaborate non-standardized set of questions with some level of flexibility. It follows that there is no one “objective” view to be discovered which the process of interviewing may bias. However, there is a very real concern about interviewers imposing their own reference frame on the interviewees, both when the questions are asked and when answers are interpreted (Easterby-Smith et Al. 2002).

All the interviewees were asked to answer the questions included in the interview guide (see *Appendix 1* for the version in Russian and *Appendix 2* used during interviews with English respondents) without any suggestive interrogations so that to “let them speak” about activities of the company and in order to avoid bias I left my questions to the interviewees open.

In the course of the research, I am aiming at conducting interviews with representatives of the following research units:

- Russian low-cost airline company Sky Express, which launches the market in 2007 and operates on domestic market.
- Norwegian low-cost airline company Norwegian, which started low-cost operation in 2002 from operating on domestic market and after some time added international routs.
- Expert point of view on the issue under consideration.
- Academic point of view with deep knowledge of low-cost flights practice in the past;

Establishing contacts with Russian and Norwegian airlines firms was quite a hard task. First, we should take into account the fact that the e spring semester devoted to writing the Master Thesis became the busiest one for Norwegian and moreover for the new-entrant Russian company. However, I conducted the following interviews:

- Professional internal expert from the Russian company-provider of low-cost carriers. Because of highly intensive Russian business environment, it took some time to make appointments for interviews. The interview was performed with two managers who



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wished not to mention their names and therefore I will call Mrs. Manager responsible for business development in the company and Mr. Manager responsible for marketing. The phone interview was held in April 2007 and lasted for approximately one hour.

– Academic point of view:

1. Mr. Alexander Bahtin – the Head of specialists and workers of the civil aviation, vice pro-rector of studies of the Civil Aviation University of Saint-Petersburg. The interview was performed in his the office in the Civil Aviation University and lasted approximately 45 min.
2. Mrs. Siri Strandenes – Professor of the Norwegian School of Economics and Business Administration (NHH) - Department of Economics. The phone interview was held in May 2007 and lasted for approximately half an hour.

Due to the intensive work and busy times of the Norwegian, I could not get in contact with anyone in the company. Therefore gathering the empirical data, I had to use information only from the secondary sources. Nevertheless, thanks to the rich variety of secondary sources, I tried to get the full picture of company's activities.

The aim of constructing the interviews in this way, using these directions, is to generalize the research. It should be noted that I followed the same interview directions both in Russia and in Norway, in order to reach the appropriate basis for future comparisons of the results and gaining the opportunity of generalizing the results about the practice of both countries.

## **EVALUATION AND INTERPRETATION**

During the evaluation of the data, I concentrate on the following interpretive methodological directions.

First, when I deal with the case study, I have at least a mix of interviews and field notes and a result of empirical work is a text analysis. Analysis, or coding, consists in operations by which data is broken down, conceptualized and put back together in new ways.

I use axial coding to 'condensate' data, that is to group and link categories of analysis (sets of ratios) to each other. To structure the axial coding process we will use the paradigm model (Figure 3) which calls for answering the following questions:

- Identify the phenomenon to be studied (definitions of the phenomena of low-cost carriers);
- Identify the conditions of directive nature, influencing the phenomenon (set of ratios).
- Specify the context in which the phenomenon takes place (Europe and Russia);
- Identify the conditions of shaping nature that intervene in carrying out and managing the phenomenon (difficulties of implementation);
- Identify the outcomes related to the phenomenon - predictable/intended or not (challenges for the company).

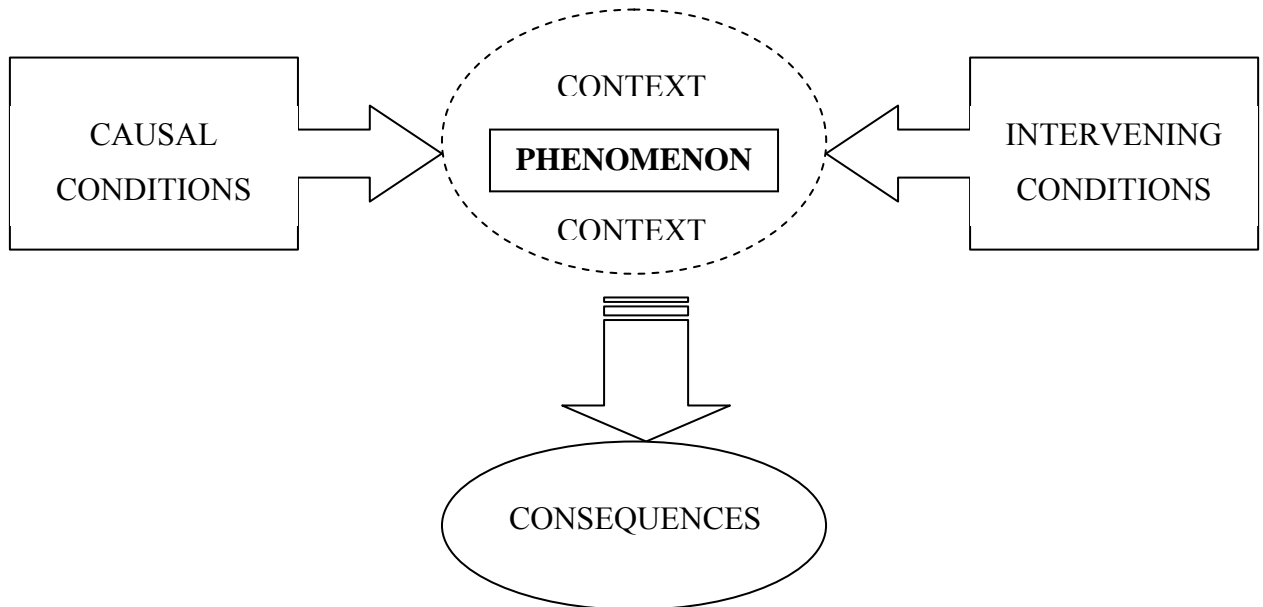


Figure 3. The Paradigm Model.

Second, textual analysis (or hermeneutics) involves the analysis of documents or transcripts one obtains from organizations. Any written or printed materials from an organization serve as data; organizational texts may also be obtained from interviews, written survey responses, or observational field notes (Meyer, 2002).

Hermeneutics (“Hermeneutics”, from Greek, “to interpret or translate”, is the theory and practice of interpretation, originally the interpretation of texts) is an integral part of the research and especially important for quality of data, its reliability and validity.

I begin with literature review, theoretical interpretation of the phenomena of low-cost flights. I worked though a lot of material, returning to some articles several times. Besides, I have my own interpretation and some questions required discussion.

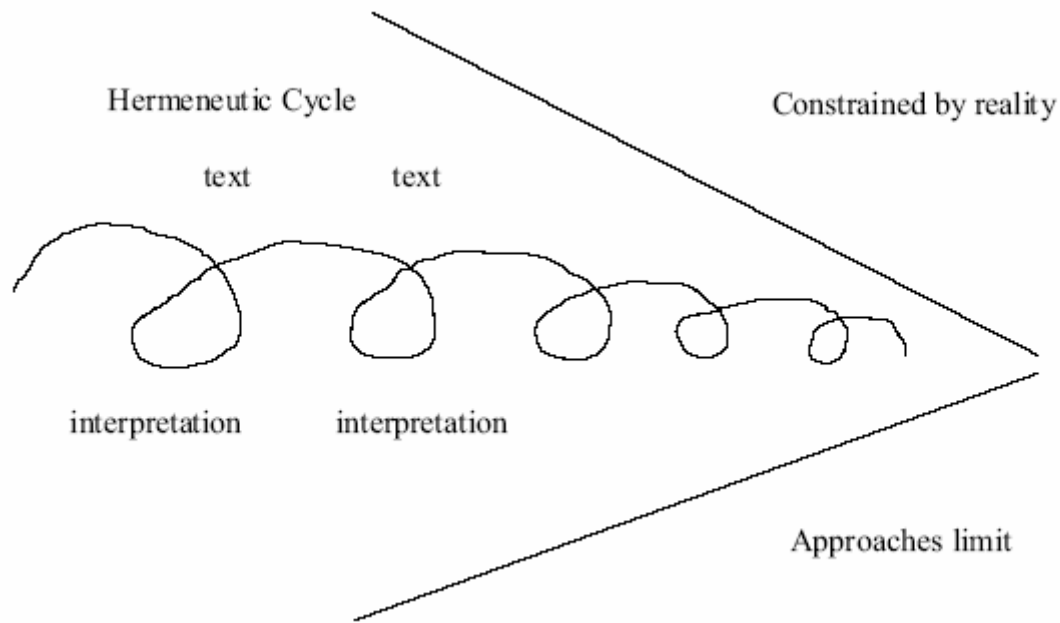


Figure 4. Hermeneutic Cycle and Reality (adapted from Ross, 2004)

Practical part of the paper is based on case study method, in-depth interviews, quantitative data collection, primary and secondary information. I carry out a text for the interviews, according to the stated problems basing on literature review. The purpose is to discover the true answers to the problems. The truth of hermeneutics is that various interpretations are usually possible for each text, empirical datum, or whatever is to be interpreted. On the other hand, the truth of foundationalism (“objectivism”) is that the text or the datum does impose a limit to interpretations.

The interaction of hermeneutics and foundationalism is the same as the interaction of interpretation and reality. Our connection to reality may underdetermine the interpretation, leaving a range of possibilities, but it does impose a limit to interpretation, determining a certain range. What hermeneutics and foundationalism really represent, however, is something logically more precise. Hermeneutics is about interpretation, it is about what is understood. Foundationalism is about reality, which is about truth, which is about what is known. (Ross, 2004). As there is no constraint in reality on interpretation, the hermeneutic cycle can spiral out of control. In other words, hermeneutics can harm the research cycle, because understanding of the problems will be ambiguously interpreted. Graphically this can be seen on Figure 4:

Hermeneutic cycle is strongly influenced by linguistic and cultural relativism. The idea of linguistic relativism is that truth created by the grammar and semantic system of particular

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language. On this view, the world really has no structure of its own, but that structure is entirely imposed by the structure of language. Two languages are used – Russian and English in my research. I worked through a lot of publicity on these languages for theoretical review and then used the information presented and summed up in English for preparation to empirical data collection. Therefore, crucial attention is paid to language, translations and interpretations.

Linguistic relativism is very important when moving along hermeneutic spiral narrowed by constrains of reality. In other words, all these nuances should be carefully taken into account when implementing the investigation.

The biggest risk in respect to reliability of information is associated with the empirical part, where two interviews are presented. In interpreting the answer of the interviewees, one can be tempted to emphasize those aspects of reality that harmonies with ones own perception of reality. One can create a subjective picture of reality, which in extreme cases can be a delusion. Interviewees also interpret reality in their own way. Hence, double interpretation takes place.

Another possible source of errors can appear when the interviewees have to speak not native language. Linguistic misunderstandings did not play here a significant role since both researchers and interviewees spoke the same language (Russian) which is native for all participants.

## **VALIDITY, RELIABILITY, GENERALIZABILITY**

Validity of the research, its abilities to stand up for a criticism is the final but not the less important scientific methodological question. It includes the terms of validity, reliability and generalizability, which I as stated before shall discuss from the point of view of the social constructionism.

Validity – does the study clearly gain access to the experiences of those in the research settings (Easterby-Smith et al. 2002)? In terms of construct validity my research is valid because I use different instruments to measure, evaluate and interpret the data collected; biased, I believe, cannot be completely removed from the researches which more or less include subjective thinking, so I shall bare it in mind for the purpose of internal validity;

according to the effect of the external validity I shall define the domains in which my research can be generalized and used.

The question of validity of the qualitative research has been already raised. The concern of validity should be seen in the light of assuring safeguards against the ubiquitousness of human error (Tschudi 1989). Validation of the qualitative research is not a simple question to discuss. I understand it according to Kvale (1989) who argues that “validation involves checking the credibility of knowledge claims, of ascertaining the strength of the empirical evidence and the plausibility of the interpretations”.

Trying to find the role of low-fares flights in practice, speaking with the interviewees, I shall start the discussion using our ‘a-priori’ knowledge about the possible benefits and theoretical frame of reference. I shall try to understand their interpretations of these meanings. This logic of providing interviews will help me to avoid the situations when interviewees are speaking about what they think the interviewer is expected to hear from them.

In addition, in the case of Russia the problem of communicative validity during the interviews can be overcome by speaking the same Russian language and having the same cultural background with interviewee.

Interview transcripts will be drawn up immediately after the interviews would be conducted and both of us are going to prepare interview transcripts independently. These transcripts will be then compared for accuracy and cross-validity.

Reliability – question whether there is transparency in how sense was made from the raw data (Easterby-Smith et al. 2002). The question of the failure of interpretation and perception is especially important in terms of subjectiveness. It mostly concerns qualitative data thus is relevant for the interviews that I mentioned above. To avoid this type of error the interview were conducted and interpreted by two people on their native language (Russian).

Generalizability – whether the concepts and constructs derived from the study have any relevance to other settings (Easterby-Smith et al. 2002). Generalizations in our research concern mostly social reality of the social groups inclined in the field of low-cost flights and should reflect and constitute the settings of this area.

## **ETHICS AND RESEARCH**

It is important for me as interviewer to be aware of the possible interests of the interviewees, and how these could be harmed by indirect disclosures of the wrong information. There is increasing debate on social responsibility and consumer well-being in business studies as there is a danger that business research, if not aware of ethical issues might lose respect or credibility (Ghuri and Grønhaug, 2002). Thus, it is important for me, especially in my study, which is implicitly connected with external world and related scandals, and I am responsible for the information to be presented in the final paper.

The results should be presented in a way that they do not cause embarrassment, disadvantage or harm to any of the participants (Saunders et Al., 2000 in Ghauri and Grønhaug, 2002). I am aware that any misinterpretation of data will lead to misleading results and is ethically wrong.

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## THEORETICAL FRAMEWORK

*This is the main part of the Work. I started with the definition of travel logistics, then moved to the highlighting such topics as price discrimination, yield management and explain their connection to the low-cost business model.*

According to the chosen research question, to my mind it is reasonable to start from the application of marketing and management principles to airline industry and give a description of the phenomenon of low-cost itself, followed by the history of the development low-cost model.

- Travel logistics
- Marketing environment
- Cost Leadership strategy in Airline Business
- Advantages and disadvantages of low-cost carriers

### TRAVEL LOGISTICS

Transporting people and goods has become one of the biggest and most complex businesses in the world. It also has become a proving ground for the most powerful business trends of the past 20 years. The definition of “travel logistics” you can hardly find in the traditional books concerning logistics, as it appeared not long ago.

According to the experts, theory of travel logistics has its future because of the development of travel services development. After careful study of number of references of travel logistics being offered, the one given by the Staffan Hertzell, senior practice manager of Travel & Logistics, seems to me as the broad and defined concretely at the same time:

*Travel logistics comprises any transportation relating to the travel industry: railway, airline, bus routes, taxis, etc.*

The special demands on logistics faced by the biggest sectors of the industry – airlines, railroads, and post and parcel services – are forcing them to develop more innovative service offerings and a more disciplined approach to operations.

According to the words of Staffan Hertzell transport and logistics companies are unlike most of the businesses they serve, “...they cannot produce inventory; they have to excel at managing

pricing, capacity, and network economics". Service providers must be able to sell essentially the same product – an airline seat or shipping slot – to different customers at different price points, depending on the market and the needs of each customer.

### *Airline Business*

To begin a work with a theory concerning this kind of industry, it is important to define areas of the competition that airline faces. Shaw (2004) underlines the following aspects:

- Economic and social need for transportation in optimum way.
- Communication during the journey. More and more companies are now investing in technological equipment on the board of the airplanes. Its possible impact in the airline industry will be discussed in further chapters.
- Today airlines are increasingly involved in the competitive leisure industry.
- In case of transport logistics, airfreight industry, airlines are only able to succeed if they propose a logistics concept based on fast transport, low inventories and limited investments in field warehousing.
- Running successful airlines requires number of services to be developed; among them are aircraft engineering, airport ground handling, data processing and management, etc.

## **MARKETING ENVIRONMENT**

Marketing environment as a theoretical background against which strategies are developed can be applied to any industry, without exceptions. Now I would like to provide an overview of general theoretical issues from this environment, which need to be considered by airlines and discuss specific impact which each of these issues should have on low cost airlines.

The literature on marketing and management (for example, Buttle, 2004; Stone, 2001; Marinel, 2005, etc.) gives a very useful model for the firm's marketing environment, which defines categories of dividing marketing factors: Political, Economic, Social, Technological and Environmental, so-called PESTE Analysis<sup>3</sup>.

Airlines cannot develop their marketing policies independently of a range of political decisions. Such industry is always intensively political. If there is a clear and important interplay between

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<sup>3</sup> Usually, Legal issues are added, to make acronym PESTEL, but in aviation industry legal issues are dealt with Political ones.



the world of politics and airline industry, the changes and development in the economy also have a substantial impact. The continuing growth gives both great opportunities and challenges to the airline industry. The opportunities represent a chance to exploit a growing market. The challenges are to accommodate the growth through suitable infrastructure development and without unacceptable environmental consequences. Social issues such as those relating to demographic trends are also significant, especially at the present time. Technology provides both a great simplicity and number of difficulties. Whilst environmental factors may threaten the whole future of the industry.

Shaw (2004) explores each component of the PESTE model in airline context, which is presented in the Figure 5 below:

#### Factors of PESTE Analysis

<u>Political</u>	<u>Economic</u>	<u>Social</u>	<u>Technological</u>	<u>Environmental</u>
Political instability / terrorism fears Deregulation and “open skies”  Marketing policies for a deregulated environment Privatization  State aid  Airport slot allocation	Economic growth and trade cycle	The ageing population  Changing family structures  Changing tastes and fashion in holidays  The uncertain, deregulation labour market Female business traveller	Internet  Video-conferencing  Surface transport investment	Global warming  Shortages of infrastructure capacity Tourism saturation

Figure 5: PESTE model in airline context (Shaw, 2004)

## Cost Leadership strategy in Airline Business

Figure 6 presents a well-known diagram, taken from Porter's "Competitive Strategy".

		Strategic Advantage	
		Uniqueness perceived by the customer	Low cost position
Strategic target	Industry wide	Differentiation	Cost Leadership
	Particular segment only	Focus	

Figure 6: Sources of competitive advantage

According to the problem statement of the research, I stop on the Cost Leadership strategy, which in airline business is very popular nowadays due to the historical changes in the airline industry. Thus, business principles that underlie Cost Leadership strategy are now very understood and straightforward. The fundamental philosophy, claimed by Shaw (2004), is simplicity. Some of the world's successful and profitable businesses took complicated processes and then simplify them, because the consequences of such complexities are severe. Shaw (2004) illustrated in pricing policy example. Usually, more than ten fares are available on a given route. Which one the passenger will choose will depend on their ability to satisfy a range of conditions such as length of stay, advanced booking, cancellation and rebooking opportunities. Such complexities make the process training reservations personnel costly and time-consuming. The point-of-sale task becomes a slow one. In its turn, this forces the consumer to turn to a travel agent to bypass inconveniences, involving airlines in costly control issues. The build up of business obtained over the Internet has been much slower for traditional airlines than it has been for Cost Leader player with its simple fare structures.

Sustaining simplicity in business processes is an absolutely main and important requirement for a successful Cost Leadership. Shaw (2004) underlines the basic features of the strategy:

Low fleet costs. Most of low cost airlines use a so-called "fleet commonality" policy, according to which the company use one type of aircraft in the fleet. LCA's adherence to one type of aircraft. The goal is to gain substantial economies in such areas as pilot training and maintenance. The most popular ones are aircraft Boeing 737 family. However, such successful

cost leader airlines as Jetblue and Easyjet retargeted to Airbus A320 and A319 respectively, because the Airbus Company offered an attractive acquisition, that it made airlines to persuade that lower acquisition costs would outweigh the costs associated with a mixed fleet.

Low Landing Fees. Since pricing advantage over rivals is the goal for successful model of cost leadership, ticket price is the target of minimization, to which all-corresponding cost items have a substantial impact.

Shaw (2004) found out that landing fees and passenger embarkation charges are an important cost item nearly for 10% of costs. If the airline is succeeded in reducing them, it this airline company have a good background to the cost leadership. Cost information of the British Midland (Table 1) Airways illustrates the principle because this company presents sustainable cost leadership on UK domestic and regional markets:

Table 1. Cost Structure of the British Midland Airways, Financial Year 2000/01, (Shaw, 2004)

Depreciation and Rental	18.2
Handling Costs, Parking fees, and Station Costs	11.1
General and Administrative	10.1
Landing Fees, Passenger Embarkation Charges	8.8
Flight Crew Costs	8.0
Maintenance and Overhaul	7.7
Aircraft Fuel and Oil	7.1
Commission	6.0
Passenger Services	5.2
Cabin Crew Costs	4.7
Navigation and En Route Charges	4.1
Reservations	3.2
Advertising and Promotion	2.2
Sales	1.5
Specific Cargo Costs	1.0
Insurance	0.8
Other Operating Costs	
	100.0%

Most of the LCA support the policy of the underutilized airports. In the expansion policy of Ryanair, the existence of the underutilized airport is the most fundamental requirement, even if it is a long way from the city. The same policy holds Southwest Airlines, looking for the unused airport, even if these are old, dilapidated and unfashionable.

Table 2 below indicates the emergence of secondary airports used by ELFAA members in major European cities:

Table 2. Use of secondary airports in major European cities (based on [www.elfaa.com](http://www.elfaa.com))

<b>City</b>	<b>Primary airport (s)</b>	<b>Secondary airport (s)</b>
Amsterdam	Schiphol	Rotterdam
Barcelona	Aeroport del Prat	Girona, Reus
Berlin	Tegel	Schönefeld
Brussels	Zaventem	Charleroi
Copenhagen	Kastrup	Malmö
Krakow	Balice	Katowice
Düsseldorf	Düsseldorf International	Cologne/Bonn, Weeze
Frankfurt	Main	Hahn
Glasgow	Abbotsinch	Prestwick
Hamburg	Hamburg Airport	Lübeck
London	Heathrow, Gatwick	Stansted, Luton
Milan	Malpensa	Bergamo
Oslo	Gardermoen	Torp
Paris	Charles de Gaulle, Orly	Beauvais
Rome	Fiumicino	Ciampino
Stockholm	Arlanda	Skavsta, Västerås
Vienna	Vienna International	Bratislava

The benefits of using underutilized airports are enormous. The gains from low landing fees, as airport operators reflect that they are better off having substantial number of passengers, who will provide commercial income for the airport from such activities as car parking and shopping. It will also be able to expand rapidly, free of the slot-availability constraints that hub airports lack.

Short Turnarounds / High Aircraft Utilization. When uncongested airports are chosen, the Cost Leader airline tries to achieve another important requirement, that of short turnarounds and high aircraft utilization. Turnarounds usually amount to 20-25 minutes instead of 50 minutes to on hour for traditional airlines. It allows additional rotations to be operated each day. In turn, this permits a wider spread of capital costs, in case of aircraft, which are owned, or of lease rentals.

These turnarounds must be built up so that they can be achieved consistently – otherwise an unacceptable punctuality penalty will result. That is why most of LCCs do not use airbridges at airports, despite the passenger's inconveniences because of bad weather. However, the benefit of this is that it allows enplaning and deplaning passenger more quickly using both front and rear aircraft exists. Some LCCs do not pre-allocate seats. It means that passengers are far more likely to be at the gate at the boarding time, and that they can be encouraged to sit down by the cabin crew in any available seat once they are on the aircraft.

Another fact that LCCs are generally “no frills” makes galley servicing a very easy and quick process, as is cleaning cabins. Indeed, many Cost Leaders airlines desired cabin crews to make a thorough clean only being given overnight, what is not possible for LFAs.

Limited On-board Service. LCCs have a choice to make on-board catering. Some of them have chosen to be completely “no frills”, that allows cheaper aircraft acquisition costs due to the absence of galley cabin, speeds, aircraft cleaning and extra seats. Others offer meals, like simple drinks and snacks, but for the relatively high prices. Thus, passenger service became a source of revenue rather than a cost item. For example, British Midland spends 5.8% of its costs on “Passenger services” according to the Table 1.

Point-to-Point Only. One of the most important reasons of LCCs' success is that airlines use point-to-point traffic. Thus, they eliminate an unacceptable level of cross-subsidy from point-to-point to connecting passengers.

Any airline, offering a transfer and connections product, at a hub have substantial additional costs. First, these are investment in communication: passengers checking in for a connecting flight expect to be given a boarding pass for their onward flight. They also assume that the luggage will be checked-in in the point-of-origin and reclaimed at the end of the flight. It is also substantial costs of luggage handling.

Provision of a connecting product will have greater costs implications. Flights are coordinated in banks, so that connections can be made in the shortest possible time. These banks require a peak availability of the resources, which is poorly utilized when the peak is over. The problem is worth by low yields from transfer traffic. A passenger making a connection has a choice available to them, because they are able to travel via the hubs of different airlines. In addition, they in turn will try to attract the passenger to choose their hub rather than of a rivals. Hence, yields are poor in the market of transfer traffic.

LCCs removed all the costs and kept the policy by concentrating on point-to-point traffic.

Simple Fares. Cost leader airlines hold up different pricing policies from traditional airlines on their ways. Revenue Management has led airlines in the direction of greater pricing complexity, with usually forty or more fares offered on one route. Most of them have different conditions. Cost leader use Revenue Management techniques, but usually with one crucial difference compared to the traditional airlines. The fact that there is one fare available on a particular route at a particular time during the ticket reservation procedure. The fare on offer varies through time: it is low long in advance of flight departure and rising as this date nears.

Low Distribution Costs. Any airline making a claim for the cost leadership must solve question of distribution costs. These are costs associated with travel agents, commissions, and thus booking fees to GDS<sup>4</sup>. The answer to the distribution problem is to use Internet. The pioneer in this filed was Easyjet, which paid no commission to any travel agent and therefore no booking fees for any GDS company. The cost savings it has achieved as a result enormous. After Easyjet, Southwest and Ryanair eliminated the use of travel agents and later entrants have almost totally relied on Internet-based direct sales.

Non-Refundable Tickets. Almost all the LCCs have a policy of non-refundable tickets, as distinct from traditional airlines with their different refund conditions, which make them more attractive and in a degree resolve the problem of overbooking. For LCCs booking can be changed but for additional fee, but no money is ever refunded. This gives the airline a better and more certain cash flow, which gets great savings in interest costs.

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<sup>4</sup>GDS – Global Distribution Systems - a group of a computer reservations system used to store and retrieve information and conduct transactions related to travel, designed and operated by airlines. It was extended to travel agents as a sales channel.

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According to the written above the characteristics of LCCs can be summarized as following:

- a single type of airplane
- a simple fare scheme (typically fares increase as the plane fills up, which rewards early reservations)
- unreserved seating (encouraging passengers to board early and quickly)
- flying to cheaper, less congested secondary airports and flying early in the morning or late in the evening to avoid air traffic delays and take advantage of lower landing fees
- short flights and fast turnaround times (allowing maximum utilization of planes)
- simplified routes, emphasizing point-to-point transit instead of transfers at hubs (again enhancing aircraft utilization and eliminating disruption due to delayed passengers or luggage missing connecting flights)
- emphasis on direct sales of tickets, especially over the Internet (avoiding fees and commissions paid to travel agents and Computer Reservations Systems)
- employees working in multiple roles, for instance flight attendants also cleaning the aircraft or working as gate agents (limiting personnel costs)
- "Free" in-flight catering and other "complimentary" services are eliminated, and replaced by optional paid-for in-flight food and drink (which represent an additional profit source for the airline).
- Aggressive fuel hedging programs.
- "Unbundling" of ancillary charges (showing airport fees, taxes as separate charges rather than as part of the advertised fare) to make the "headline fare" appear lower.

Not every low-cost carrier implements all of the above points (for example, some try to differentiate themselves with allocated seating, while others operate more than one aircraft type, still others will have relatively high operating costs but lower fares). Nonetheless these are general characteristics, most of which apply to any given low-cost carrier.

### **Advantages and challenges of low-cost airlines**

When companies implement cost leader strategy they intend to be succeeded but they should understand and predict possible problems. Every decision reflects both positive and negative consequences (advantages and disadvantages).

The authors of the article “Liberalisation of European Air Transport”<sup>5</sup> highlighted the main groups, which became beneficiaries of LCC.

***Benefits for consumers:***

Consumers are the main beneficiaries with the appearance of LCC in terms of greater choice of service providers and destinations as well as reduced airfares in general for travel within Europe. The lower fares on offer have dramatically increased the numbers of passengers who can now afford to travel by air and has brought enormous cost savings to the travel budgets of many businesses across Europe.

*Consumer choice increased.*

- Liberalisation took away the barriers so there appeared a possibility for new entrants. Since that time the number of new airlines increased dramatically. Only national airlines and small number of regional carriers were allowed to operate on the European market. According to the European Commission, the number of scheduled airlines in Europe increased from 77 in 1992 to 139 in 2006. Many entrants launched the market with the low fare policy. In its turn national airlines adopted low fares strategy too setting up low fares subsidiaries, such as SAS Snowflake, KLM’s Transavia/Basijair, BA’s ‘go’ (subsequently acquired by EasyJet), Lufthansa’s Germanwings.
- European consumers can now choose between a variety of airlines and are no longer bound to their respective national carriers. This resulted in that both low fares and traditional airlines compete based on price, network, customer service, etc.
- Greater choice of schedules, frequencies and airports to fly from. Before liberalization air services agreements had artificially restricted traffic on many routes. Deregulation created new business opportunities that have been exploited by the LFAs, who offer higher frequencies and lower fares on these trunk routes, usually to secondary airports in a close proximity to the main airport for the area. As a result, traffic overall has surged on many routes.
- The number of the served direct routes has also increased significantly because of the growth of LFAs, whose business model involves direct (“point-to-point”) as opposed to connecting (“hub-and-spoke”) services. Traditional airlines such as British Airways, Air France and Lufthansa have followed the “hub-and-spoke” model and have abandoned many direct

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<sup>5</sup> <http://www.elfaa.com>

<sup>6</sup> Source: European Commission, DG TREN, [http://www.europa.eu.int/comm/transport/air/rules/bilan\\_en.htm](http://www.europa.eu.int/comm/transport/air/rules/bilan_en.htm).



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services opting instead to carry people through their major hubs. Many regional airports have suffered serious cutbacks in passenger volumes and the number of scheduled services from their airports

LFAs, by contrast, offer direct services to these regional airports, thereby replacing the services abandoned by the network carriers, and have opened up completely new routes that previously had no direct service at all.

#### *Fares became lower*

- The significance growth of number of LFAs and hence an increased competition in Europe have led to a dramatic decline in airfares. Strong competitive pressure from LFAs on major routes resulted in that the traditional airlines lowered their ticket prices in order to compete and to keep their market share.

However, such situation is only on the routes where low fares competition is present. Where routes are presented by one or two traditional airlines without any competitive pressure, the fares generally continue to keep at a high level. The European Commission observed in 1999 that “the level of fares decreases when the market structure passes from monopoly towards duopoly or routes with more than two carriers”<sup>7</sup>.

With the opportunity to book on-line, consumers choose the simple, transparent fare structures offered by low fares airlines. Combined with very low fares, this transparency in the pricing structure has attracted a completely new segment of consumers flying with the low fares airlines. Various passenger surveys indicate that a large portion of people flying with low fares airlines have never flown before or would not have travelled by air had it not been for low fares.

#### ***Benefits for airports:***

Regional and secondary airports get the most benefits thanks to liberalisation of airline transport, which became the representatives of low fare services. The situation is clearly depicted on the Figure 7 below:

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<sup>7</sup> European Commission, The European airline industry: from single market to world-wide challenges, 20 May 1999.

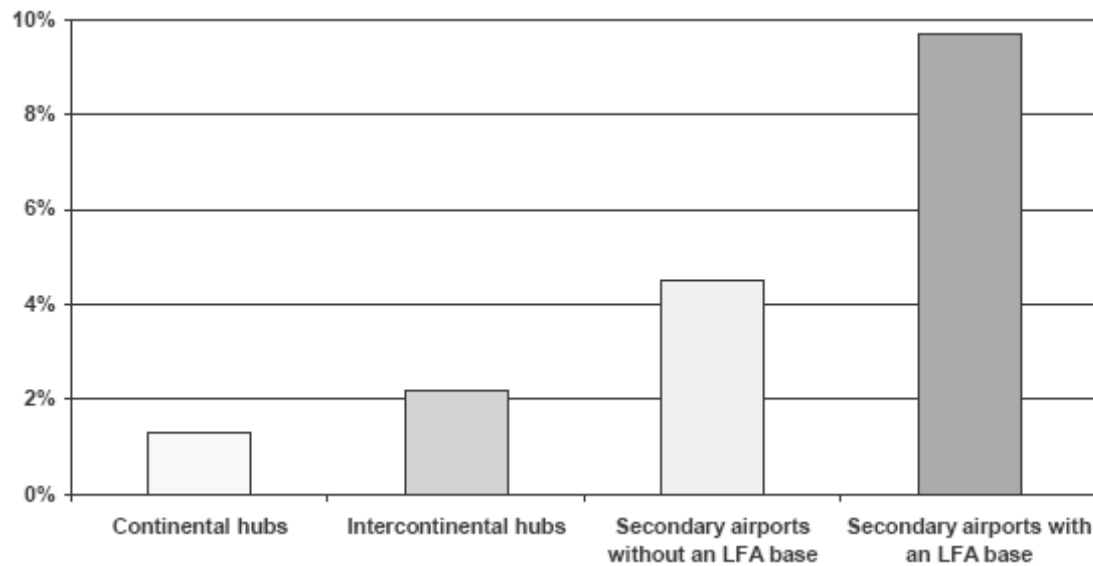


Figure 7. Growth rate of European airports 2002/2003

#### *Emergence of low cost airports:*

Since liberalisation in air transport airports could not dictate the prices and conditions for operating to airlines. Airports forced to change their business policy since they have to compete with each other for business from the new entrant airlines.

Now airlines have a relatively high level of freedom of choice over which airports they could operate their services. The decision is therefore often based on the cost of operating into any one airport compared to another.

The main difference now between traditional and low cost airports is that the latter no longer consider aeronautical charges to be their main source of income. Instead, they concentrate on the non-aeronautical or commercial side of the business realizing that great opportunities now exist for them to significantly increase revenues and profitability in this area<sup>8</sup>.

Non-aeronautical costs are lower:

- Large numbers of passengers attract businesses to the airport. Car rentals, shops, banks, post offices, restaurants, bars, etc., consider it viable to locate themselves at an airport with high passenger volumes. The airport collects rental and concession fees from these businesses, which tend to increase proportionally with the increase in passenger numbers.

<sup>8</sup> The Boston Consulting Group, Airports – Dawn of a New Era.

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- Car parking is another important source of revenue. The car parking charges at low cost airports, which usually have an abundance of space available, are usually significantly lower than those at major airports where car-parking capacity is often constrained. Higher passenger numbers have led to increased demand for parking facilities and higher parking revenues.
  - As low cost airports are often located some distance from the main city centres they serve, the need to offer a regular surface transportation service often arises. Airports either organise the shuttle transport in-house, or contract it out and receive a concession from the operator. Either way, the transport of passengers to and from city centres is a significant revenue source for low cost airports.
  - Airports with high passenger throughput are also a great advertising medium. Airlines, hotels and other tourist attractions in the region, car rentals, neighbouring regions and cities all find it very effective to advertise at such airports. They realise that airline passengers are the best target of travel and tourism advertising, and are therefore willing to spend considerable amounts to advertise at these airports. Low cost airports pay great attention to creating as much advertising space as possible, to enable them to secure substantial additional revenues.

*Traffic growth at low cost airports:*

Low cost airports model got the possibility to successful development. Other airports, try to compete by offering low cost, efficient facilities to the growing number of LFAs. Low fares services gave many secondary airports the international recognition which most of them previously lacked. Secondary, regional, airports increasingly provide a competitive alternative to the congested, expensive hub airports

Recent developments showed that popularity of using regional airports gave the following:

- The hub-and-spoke network model applied by traditional airlines lends itself to congestion (and increased pollution) at and around major airports.
- Emergence of low fares airlines offering direct, point-to-point services has rejuvenated previously underutilized regional and secondary airports.
- Increased competition from secondary and regional airports has forced not only these but also some major airports to seek efficiencies and lower their charges.
- Those major airports that do not face competition are still able to abuse their monopoly position and charge excessive prices.

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**Benefits for regions:***Regional development and integration*

- Increase tourism
- Encourage the location of business near low cost airports

The Committee of the Regions has told the European Commission that new guidelines on state aid for regional airports must take "due account" of the positive role played by low-cost airlines as a catalyst for economic development and job creation.

The European Union's Committee of the Regions issued a report, titled "Low-cost airlines and territorial development" (<http://www.cor.europa.eu>). In particular, the report urges the Commission's guidelines to take account of:

- the importance of identifying regional airports and regional air services as an essential tool to help regional and local authorities promote delivery of territorial cohesion and development;
- the contribution that the development of regional airports and regional air services make to wider employment creation, regeneration, social inclusion and regional and local economic development programmes;
- the significant role that low-cost air services can play in supporting the sustainable economic development of small and medium sized regional airports;

The Committee observed that "the availability of regional air services, and in particular low-cost air services, operating from regional airports improves access to the global economy. This, coupled with the lower labour costs and facilities costs associated with the more remote regions, can encourage the business community to locate new economic investment within the region. Existing businesses in the region could develop their market share by being able to reach other parts of the Member State, the EU and the rest of the world"<sup>9</sup>

*Tourism*

Liberalization contributes a lot in European tourism. Before liberalization not everyone could afford to travel by air. Many regions lacked a direct connection with the hub airports, so such regions suffered from absence of number of potential tourists. The access to those regions was reached only by other means of transport, such as ferries, trains, cars and busses.

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<sup>9</sup> <http://www.elfaa.com>H. P25

Even on major tourist routes, the service offered was usually highly seasonal, with limited capacity and high fares. Related services in these destinations, such as hotels and restaurants, were, as a result, also highly seasonal and therefore had to charge higher prices in the peak season in order to recover losses in the off peak.

There are three categories of benefits, which low cost airlines bring to European tourism:

- Number of new tourist destinations increased. LFA help to increase “brand awareness” of not only the megalopolises, but also provincial towns and regions.

Examples of tourism destinations are represent in the Table below:

Table 3. Examples of tourism destinations discovered for international air travel by low fares airlines (Source: [www.elfaa.com](http://www.elfaa.com))

<b>Country</b>	<b>New international tourism destinations</b>
Austria	Graz, Linz, Klagenfurt
Belgium	Charleroi
Denmark	Esbjerg
Finland	Tampere
France	Bergerac, Rodez, Limogez, Carcassonne, Pau, La Rochelle, Nimes, St. Etienne, Tours, Poitiers, Dinard,
Germany	Karlsruhe-Baden, Altenburg, Hahn, Tempelhof, Münster (Osnabrück), Erfurt
Ireland	Knock, Derry, Kerry
Italy	Bari, Pescara, Ancona, Brindisi, Palermo, Alghero, Trieste
Norway	Haugesund
Poland	Gdansk, Poznan
Slovakia	Košice
Spain	Bilbao, Girona, Jerez, Murcia, Santander, Valladolid, Zaragoza
Sweden	Malmo, Nyköping
United Kingdom	Blackpool, Bournemouth, Newquay

More spread traffic distribution during the year. Charter airlines usually concentrate on the destinations during summer and winter months, so-called season flights. LFAs offer year round flights to all of the destinations they serve. Therefore, they spread the traffic in the most popular

tourism destinations giving a more secure and steady income to hotels, restaurants, car rentals and other tourism-related businesses.

LFAs have also popularised mid-week holiday travel to the regions. The lowest fares are offered during off-peak travel times (generally between Monday and Thursday) which incentivises customers, particularly price sensitive groups (such as students travelling on field trips etc.), to fly outside the weekend peaks. More evenly distributed holiday traffic throughout the week helps to avoid congestion at the airports and allows hotels, restaurants, etc., in tourist destinations to maintain higher booking rates during weekdays.

### *Employment*

The appearance of LFA has raised employment in many sectors of the economy of regions. There are three main types of employment influenced by low fares airlines – within airlines themselves, at airports and in regional businesses (including tourism related industries).

### *Environment*

Low fares airlines aim at a sustainable and environmental friendly business. LFAs are actually minimizing environmental impacts given the more efficient nature of their operations and the fact that they generally operate much newer fleets. It concerns the most popular aircraft type among low-cost airlines such as Boeing 737, Airbus A-319 and A-320. These aircrafts are the most technologically advanced and energy efficient aircraft in the industry. The use of these aircraft minimizes fuel burn and noise emissions.

The following are the main factors contributing to lower environmental impacts of LFA's.

- More efficient seat configuration and lower fuel consumption. For example, the Boeing 737-800 in service with a traditional airline will generally only have 162 seats on this aircraft due to business class seating and on-board catering, whereas an LFA can configure this aircraft to accommodate up to 189 seats, or 17% more. Together with the fact that low fares airlines normally achieve on average at least a 10% higher load factor than traditional airlines, i.e. 80% as opposed to 70%, this efficient aircraft configuration decreases the average energy use per passenger in the low fares airline sector by approximately 25% compared to traditional airlines.
- Decreased noise emissions. The modern fleet used by ELFAA members exceeds all current noise limitations. Moreover, low fares airlines operate to less congested airports, which are generally located in less densely populated areas with lower levels of aviation activity

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compared to the main hubs. Hence, the noise nuisance generated by LFAs is minimised. LFAs also generally avoid night operations, which further reduces overall noise nuisance.

- Direct services lead to less connecting flights. Because LFAs operate direct flights, passengers only have to take one flight as opposed to having to connect through congested hub airports, i.e., using two or more flights. The fact that LFAs operate to regional secondary and underutilized airports also helps to avoid congestion on the access roads around main hubs with the frequent traffic queues that tend to result and allows for more equal traffic distribution. Busy airports can lead to ‘holding patterns’ where aircraft have to circle for minutes in the air before they are allowed to land leading to extra fuel burn and emissions.
- Reduced waste. The lack of “frills” offered on low fares services significantly reduces the amount of waste normally generated by traditional airlines. LFAs do not usually hand out newspapers and do not offer “free” meals and drinks, all of which generate huge amounts of waste on traditional airlines.

All the aspects of the advantages listed above can also have “a flip side of the coin”. Consequently, the critics of low-cost airlines stress the following disadvantages.

There are two main disadvantages to low-cost airlines from an operational standpoint.

1. Low-cost carriers have to outsource everything: maintenance, pilot training, and often ground staff at the airport. Often, this makes their service sub-par: in Valujet's case, it killed the company by burying the entire complement of a DC-9 alive in Everglades mud. At the very least, it means that the airline cannot operate its planes as cheaply as the majors do, which means that the lower fares have to be compensated for elsewhere.
2. Low-cost carriers also (usually) have much less financial leeway than their major brethren: if an airplane crashes, or something else goes wrong, the entire company is screwed.

#### *Shortcomings for customers:*

The main shortcoming for customers expressed in *inconveniences*. Low cost airlines are characterized by limited in flight services, thus it narrows down the segment of customers who need special services during the flight, for example, business class consumers. Customers usually lack of flexibility of services and usually no changes permitted on the lo-cost flights. Because of the type of a craft, distances between seats are minimal, usually seats are without head cushions and it is not possible to regulate seat's angle of slope. Timetables usually unsuitable because of the airport charges lower. Thus big segment of tourist cannot use the services of LCC.

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*Shortcomings from regional airports:*

The main disadvantage is that some transfers to planned destination may take longer than from larger airports. In addition, costs of transfers can be high and the total sum of travelling can be the same if the customer flies traditional airlines.

*Shortcomings for environment:*

The environmental spokesman for the Green Party, Winfried Hermann, called the rock-bottom prices of the low-cost airlines a “scandal” for the environment, since they have drawn passengers from less polluting modes of transportation to airplanes. The debate over the benefits and disadvantages of low-cost carriers comes just a week after several environmental groups in Germany introduced a campaign warning of the environmental damage resulting from increasing air traffic. In Hahn airport, hub to many of Germany’s budget carriers, one million passengers passed through its gates last year, an 81 percent increase over the year before. Hapag-Lloyd has estimated that between 5 and 6 million passengers fly no-frills every year. Environmental groups say such air travel is a climate catastrophe in the making, since airplanes emit three times the amount of greenhouse gases that automobiles do. The no-frills travel boom, according to Germany’s green lobby, is the country’s “climate killer #1.”

When looking through the researches a lot of possible challenges as well as advantages are pointed out. Both problems and advantages are associated with customers, producers, environment and regions. Thus, for low-cost airline company it is very important to “tip the scale” to the advantages of its services. It takes time and additional efforts to overcome the difficulties.

## **YIELD MANAGEMENT**

Based on real-time demand forecasting by market micro-segment and an optimization model, yield management (also known as revenue management or real-time pricing) is an economic technique to calculate the best pricing policy for optimizing profits generated by the sale of a product or service, based on real-time modelling and forecasting of demand behaviour per market micro-segment<sup>10</sup>.

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<sup>10</sup> [http://www.optims.com/UK/high\\_profits.html](http://www.optims.com/UK/high_profits.html) - “Definition and History of Yield Management”, Amadeus



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This scientific method for calculating prices made a revolution in the airline industry in the early 1980s. It offers an excellent solution to the problem of comparing supply and demand thanks to differentiated pricing and systematic control of the inventory for sale in each price category. All players benefit from using this concept: the producer gains in increased turnover and revenue; the end-user enjoys lower prices for the same quality of service.

It was the American airlines, which practiced yield management in the 1980s. Yield Management originated in the United States at the beginning of the 1980s with the deregulation of the airline industry<sup>11</sup>. Major American airlines had to compete with a highly competitive, new environment created by the distribution possibilities offered by electronic distribution systems: GDS (Global Distribution Systems) and by the number of low-cost airlines entering the market, such as PeopleExpress, whose operating costs were half those of the major airlines (American, Delta, United, TWA, etc.).

The success of yield management goes hand in hand with the development of electronic distribution. In order to understand the true significance of yield management, it is important to note that it developed in the airline sector in parallel with the implementation of electronic distribution in the form of the first GDS - Global Distribution Systems<sup>12</sup>.

GDS makes it possible to display airline company products over an extensive network of travel agencies (GDS today serve 500,000 travel agencies) (<http://www.sabretravelnetwork.com>). Development of electronic distribution succeeded in a period when an agency had to telephone or send a telex to the airline company in order to reserve a client's trip. It represented an important revolution since regulations concerning pricing and access to availability had to be formalized before any product could be distributed. If not, the airline company would have lost all control over its inventory. It is easy to understand the analogy with the Internet, which already gives information on product price and availability not to just several thousand travel agencies but to millions of consumers and companies. If not for the guarantees offered by yield management, companies assisting in e-commerce would, at worst, have the risk of losing control of their inventory and, at best, be unable to take full advantage of the possibilities inherent in these new distribution channels.

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<sup>11</sup> <http://www.aa.com>

<sup>12</sup> <http://www.sabreairlinesolutions.com/about/history.htm> - "History of Sabre Airline Solutions". Sabre Airline Solutions (2006)

Yield management is indispensable as a tactical tool. Given the context of deregulation and the development of electronic distribution, the major companies used yield management as their main tactical weapon in their struggle to preserve market share while maintaining profitability. Those who implemented the most effective yield management systems (especially American Airlines and Delta Airlines) were in fact the companies who adapted best to this new competitive environment (Kalyan & Garrett, 2005). The companies that did not invest or waited too long to invest in these tools have disappeared (People Express, PanAm).

American Airlines calculated that systematic use of yield management enabled the company to generate 1.4 billion dollars in additional revenue between 1989 and 1991, whereas profits from the AMR holding represented 892 million dollars over the same period (Handbook of Airline Economics, 1995).

Donald Burr, former CEO of People Express, summarized the reasons behind the company's 1996 bankruptcy as follows: "We were a vibrant, profitable company from 1981 to 1985, and then we tipped right over into losing \$50 millions a month. We were still the same company. What changed was American's ability to do widespread yield management in everyone of our markets. We had been profitable from the day we started until American came at us with Ultimate Super Savers. That was the end of our run because they were able to underprice us at will and surreptitiously. There was nothing left to defend us."

Yield management is thus a necessary tactical weapon that ensures the profitability, if not the viability, of any business operating in a highly competitive environment. In the 1990s, many sectors of business began to practice yield management. Following its appearance in the airline industry, yield management began in the early 1990s to penetrate other sectors of activity, first in the United States and then in Europe.

## **Yield Management System**

Enterprises that use yield management periodically review transactions for goods or services already supplied and for goods or services to be supplied in the future (McCaskey, 2006). They may also review information (including statistics) about events (known future events such as holidays, or unexpected past events such as terrorist attacks), competitive information (including prices), seasonal patterns, and other pertinent factors that affect sales. The models attempt to forecast total demand for all products/services they provide, by market segment and price point.

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Since total demand normally exceeds what the particular firm can produce in that period, the models attempt to optimize the firm's outputs to maximize revenue.

The optimization attempts to answer the question: “Given our operating constraints, what is the best mix of products and/or services for us to produce and sell in the period, to generate the highest expected revenue?”

Optimization can help the firm adjust prices and to allocate capacity among market segments to maximize expected revenues. McCaskey pointed that this can be done at different levels of detail:

- by goods (such as a seat on a flight)
- by group of goods (such as all the seats on a flight)
- by market (such as sales from Saint-Petersburg and Moscow for a flight going St. Petersburg – Moscow – Novosibirsk)
- overall (on all the routes an airline flies)

Yield management is particularly suitable when selling perishable products, i.e. goods that become unsellable at a point in time (for instance, air tickets just after a flight takes off). Industries that use yield management include airlines, hotels, stadiums and other venues with a fixed number of seats, and advertising. With an advance forecast of demand and pricing flexibility, buyers will self-sort based on their price sensitivity (using more power in off-peak hours or going to the theatre mid-week), their demand sensitivity (must have the higher cost early morning flight or must go to the Saturday night opera) or their time of purchase (usually paying a premium for the luxury of booking late).

In this way, yield management's overall aim is to provide an optimal mix of goods at a variety of price points at different points in time. The system will try to maintain a distribution of purchases over time that is balanced as well as high.

Good yield management maximizes (or at least significantly increases) revenue production for the same number of units, “by taking advantage of the forecast of high demand/low demand periods, effectively shifting demand from high demand periods to low demand periods and by charging a premium for late bookings” (McCaskey, 2006). While yield management systems tend to generate higher revenues, the revenue streams tends to arrive later in the booking horizon as more capacity is held for late sale at premium prices.

Firms faced with lack of pricing power sometimes turn to yield management as a last resort. After a year or two using yield management, many of them are surprised to discover that they have actually lowered prices for the majority of their opera seats or hotel rooms or other products. That is, they offer far higher discounts more frequently for off-peak times, while raising prices only marginally for peak times, resulting in higher revenue overall.

By doing this, they have actually increased demand by selectively introducing many more price points, as they learn about and react to the diversity of interests and purchase drivers of their customers.

## **Ethical Issues**

As Yield Management is a type of price discrimination, as I mentioned earlier, some question the morality of the participating firms' motives.

1. The ethical issues include the firms manipulation of personal information to judge one's demand for a service or product; for example, it is rumoured that airlines see who the purchaser is and use the frequent flyer information (say for example, age) as an input to the formula which decides the price (Cooper, 2004).
2. Another ethical issue is due to the underlying principle of yield management. That is, different prices are charged to different people for the same product or service to increase revenue. A firm that practices yield management through yield management systems relies on forecasts, and the manipulation of information via online transaction processing systems to find out the price to maximize revenue (Cooper, 2004). It is understandable that some consumers see yield management as unfair and discriminatory. In the end it is up to the consumer to support a firm that relies on yield management. However this can be difficult in industries that it has become the norm, such as the airline industry.

## **Questions of Effectiveness**

There have recently been questions about how effective yield management is. A firm that wants to satisfy its customers and have them come back is putting their customer relations in jeopardy by using YM practices. For instance, American Airlines, which was a pioneer in the innovation of yield management systems, estimated that the utilization of YM increased its revenue by \$1.4

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billion between 1989 and 1991<sup>13</sup>. While this stat is impressive and shows how YM can be effective, it is also misleading.

Many argue that the benefits of offering different price points to customers, which results in additional revenue by stimulating demand, are short-lived. The costs of lower customer satisfaction, loyalty and the loss of relationship marketing can have longer more serious effects and in the end the implementation can do damage to the firm. As American Airlines was a pioneer with yield management, it is obvious that the innovation will result in a large increase in revenue. However, as the rest of the industry catches up with the technology of the YM systems, the competitive advantage can be lost, while the long lasting costs might remain. Therefore, it comes down to a cost-benefit situation for the firm. The extra revenue now is the benefit and loss of goodwill and possibly a drop in revenue in the future is the cost. It is, of course, up to the firm to forecast if the benefits outweigh the costs.

An airline decision to adopt a differential pricing system should not be taken lightly. It may lead to anger amongst some travellers who think that they are being overcharged. It will, though, if correctly applied, bring significant benefits both to the airline in terms of its profit performance and to its customers (Shaw, 2004).

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<sup>13</sup> [http://www.optims.com/UK/hight\\_profits.html](http://www.optims.com/UK/hight_profits.html) - "Definition and History of Yield Management". Amadeus

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## EMPIRICAL PART

*The empirical part just reflects the facts I have learned during the interviews and from secondary sources, while analysis includes both my interpretation of these facts and a certain order of their presentation, data structure, according to the theoretical models.*

Each presentation of two cases concerning the company in the empirical part begins with the context of the research. These parts are devoted to the airline infrastructure and market conditions in Russia and Norway. As the geographically the investigation is realized in these two countries, description of the context of the research seems reasonable and important for the analysis. This information is taken from the secondary sources.

To research low-cost airline in Russia one low-cost airline company Sky Express were explored. In addition, experts' opinions are taken to give the possibly of full picture of the situation on the Russian market nowadays and future perspectives. One expert was interviewed personally: Bahtin A. – the Head of specialists and workers of the civil aviation and vice pro-rector of studies of the Civil Aviation University of Saint-Petersburg. I also use information from secondary sources – articles and on-line interviews of the consultant Rybak B., CEO of the consulting firm Infomost. In the research of Norwegian I used mostly secondary data and expert opinion of Siri Strandenes

## CONTEXT OF THE RESEARCH ON RUSSIAN MARKET

Airline market in Russia has considerably changed from the Soviet times. In the beginning of 90s after a long decrease industry began to recover and increase production value. Then the group of leaders formed and they began property redistribution. Experts marked that it goes with number of unfavourable factors: losses of main activities, lack of airline fleets, high tariffs on fuel and improvement of competition from foreign airline companies.

In specialists' opinion low-cost airlines market is the developing part of airlines market in Russia. Now there are several European carriers, operating on the Russian market – Germanwings, DBA, Germania Express, WindJet - they have flights from Russia to Germany and Italy - and Norwegian, to Norway respectively.

Existence of the airlines company operating with low prices just on local, domestic, market ripen long ago. Against the explosion of the international passenger traffic flow, domestic flights experience no better days, demonstrating much slowly rates of growth. According to the statistics of the Ministry of Transport of Russia (<http://www.mintrans.ru>):

<b>Passenger traffic in bil. pass. km</b>	<b>2004</b>	<b>2005</b>
<i>International flights</i>	43.72	45.79
<i>Domestic flights</i>	39.27	39.99
<b>Number of passengers in mln.</b>	<b>2004</b>	<b>2005</b>
<i>International flights</i>	14.90	15.88
<i>Domestic flights</i>	18.89	19.22

Thus the changes in percentage are 1.3% per year for domestic flights and 6.5% per year for international. However, domestic flights dominate in amount of number of passengers: in 2005 it was conveyed 19.2 mln people, but on the international flights Russian companies serve only 15.9 mln people. If we take into account those who flight abroad with international airline companies, total numbers will be not in favour of domestic companies.

The fact is in the expensive tickets. For instance, if you want to come at the town 1000-1500 km away from the Moscow, you will pay four times more by plane compared to the railway. High prices on the airlines tickets scare the majority of the passengers and in the minds of Russians the airplane turned into the mean of transport for rich people.

I have to mention that technical services are not perfect, especially well known and popular system of e-ticket. International Air Transport Association (IATA) defined 31 of December 27 as the last date of innovations implementation by all the airline companies in the world. The main target of IATA is minimization of expenses and simplification of the business. Paper blanks are heavy cost item. Moreover, delivery of blanks, their recording are also should be taken into consideration. Moreover, the passenger has to pay for all the items. E-ticket solves this problem.

In the end of January Department of Justice in Russia officially proved the document of Ministry of Finance, which legalizes e-ticket in Russia. In distinction from European countries in Russia passenger will be given a boarding pass and a cash register receipt. However, imperfection and shortcomings of Russian legislation has its own consequences: implementing the innovation

companies have either to suffer losses or to find legislating omissions trying to escape unwanted expenses. Experts believe that because of these difficulties e-ticket will be claimed not for more than 3% of all the passengers in nearest future.

As such, first e-tickets appeared on the Russian market before the law. European airline companies like British Airways, Lufthansa, and Swiss Air ignored the absence of legislation base and from 2004 equipped the airports with the necessary software and check-in desks for passengers with e-tickets.

First Russian airline company who began to sell tickets through the Internet was Trnsaero in 2005, and then Aeroflot, Siberia, Uralskie avialinii continued such innovation. These companies beard millions of expenses moved to the international reservation systems (Sabre, Gabriel, Amadeus, and Galileo). Considering that these measures are quiet expensive, Aeroflot, AirUnion and Siberia cooperated and worked up the program of joint equipment in the airports. As the incentives for the passengers to buy tickets through the internet, these companies offered discounts form 5% (Siberia) to 25% (Uralskie avialinii), stimulated with special offers (Transaero). At the present according to the expert evaluations 5-6% of ticket sales are done through the Internet.

## **“SKY EXPRESS”**

Russian Airline Company Sky Express became the first low-cost airline in Russia. Sky Express was established in March 2006 and launch the market with the regular air transport operations in January 2007. Corporate entity calls ZAO “Nebesnyj express”. The project is invested by main stockholder, CEO of “KrasAir”. On the first stage the company decided to invest 35 mln dollars, on the second one – 70 mln dollars, of which about 20 mln is invested by the European Bank of Reconstruction and Development.

As of May 2007 air fleet of Sky Express consists of four aircrafts Boeing 737-300 with 148 seats. All the aircrafts go to the operational leasing on five years. Towards the end of 2007 the company plans to have a fleet of 16-18 Boeing 737-300 and Boeing 737-500 with 133 seats aircrafts. Fine maintenance check is carried out by “Vnukovsky aircraft-maintenance plant – 400”, regular technical inspections are held in Ireland, and more serous aircraft repairs are done by Lufthansa Technology. In the first half of 2007 the company plans to transfer 600 thousands



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of people by six aircrafts, in a year – 3.5 mln people by 16 aircrafts. The company plans to overstep breakeven-point during 3-4 years after starting the activity.

The company operates in the Moscow airport Vnukovo. Sky Express chose this airport because of several reasons.

## **Destinations**

First destination was opened between Moscow and Sochi in the end of January, and for the moment the company operates at six routs: Moscow-Sochi, Moscow-Murmansk, Moscow-Rostov, Moscow-Kaliningrad, Moscow-Tjumen, and Moscow-St. Petersburg. By the words of Elena Ponomoreva, Assistant Director and Responsible for the business development, it is planned to open six destinations more in the end of 2007. The company operates in the Russian cities where Sky Express which situated in the European part of the country.

Estimated traffic volume is 2 – 2,5 mln passengers in 2007. Estimated revenue is 200 mln dollars.

## **Strategy**

The company operates in the domestic market of Russia, on the European part of the country using cheap tickets to stimulate market demand and attract new segment of customers.

According to the words of Mr. Manager, goals of the company in the long run can be stressed as follows:

“From the commercial point of view 20 cities are interesting to us at least, and we shall try to come nearer to this figure at the end of the second year of the activity. And if our model will work, we should enter other consumer segment”. On the question about “other consumer segment” Mrs. Manager also stressed that within last 10-15 years the quantity of passengers, which use an air transport in Russia, does not increase, and sometimes even decreases. “Our model is targeted to increase the quantity of consumers using aviation services. We aspire to increase mobility of the nation, we want Russians fly as often as Europeans”. According to the statistics, the average American flies 7 times per year, the European - 3-5 times per year, and the Russian – 0.5 times per year. Thus on the average, one person flies once in 2 years. “Our aim is not to lure away clients at traditional airlines, those who usually fly, but “to lift in the air” the

segment of the population which did not use aviation services because of high prices for a long time”. They want to increase capacity of the industry as a whole. The average age of the fleet is 12 years.

Their business plan is elaborated for 5 years, and they are going to cover 20 cities in Russia located on distance from 800 to 3000 km. During this period the company does not intend to come out with international flights.

The main short-term goal by the words of Mr. Manager is load factor. Now the highest frequency of flights is on the flight Moscow – Sochi: four flights in a day. On this direction loading amounts to 75 %. It is very high parameter. The second direction, Moscow – Rostov loading amounts to 60 %. “We are new low cost carrier and consequently we consult with two “neighbours”: low-cost carrier Sky Europe which flies from Poland and Hungary to Europe, and Hungarian Wizz Air. For comparison, in the beginning of their activities loading amounted to 30-40%”.

## **Pricing policy**

The price range for normal ticket prices is between RUR 500-4200 (NOK 115-970). Concerning pricing policy Mrs. Manager claims that they are not a discounter. In press this company calls differently, but “we understand, that our model is not clear one for the moment. However it is necessary to explain, that we do not work by the following principle: today we reduce prices for the tickets, and tomorrow shifting on the shoulders of other passengers’ half-received profit, again up the prices. Our business plan is elaborated for 5 years and during this time price politics Sky Express will not change”.

The price on the ticket depends on two factors:

- time when the ticket is purchased,
- quantity of passengers on a particular flight, buying out these tickets beforehand.

Thus, recently the company have opened summer schedule which is opened till October – and during these six months on the direction Moscow – Sochi the most cheap tickets has already bought. On each flight 30 tickets are sold under the lowest price. When they are purchased, next class of tickets is opened and prices on them are higher. Number of ticket, which will be sold for a particular tariff, is counted by the special computer program, where a mathematical algorithm

is used – the system of yield management. It analyses different factors: demand and supply behaviour, market capacity, tariffs of competitors, etc. On the different flights the system sells tickets in different tariff proportions. If the demand behaviour is higher than usual one, the tariffs go up and vice versa. Therefore, closer the time of departure, higher price for the tickets, because the cheapest ones have already purchased.

By the words of Mrs. Manager, however even in this case their aim is to set the price of the ticket between the price of a compartment in the train on this direction and the lowest price of the ticket on the traditional airlines. It is done so that the person travelling by train considers it possible to buy the ticket on the plane. In such a way they try to lift passengers in the air as much as possible, and it will not only reduce a share in quantity of passengers on the traditional airlines but increase market capacity in total, they will increase quantity of passengers for the traditional airlines also.

### **Company's Costs**

Referring to the words of Mrs. Manager the company sets of low prices and reduce the costs due to the following economies on:

- Single-type aircraft fleet
- Rational organization of rout network
- On-board services: meals and drinks can be purchased during the flights, also in the nearest future the company plans to sell on board “basic consumer goods”, such as batteries, headphones, set for pillows and glasses for sleep, etc.
- Increased passenger traffic flow

### **Problems and challenges**

Mrs. Manager was asked her opinion about the threat of new entrants, how the company will operate another low-cost carrier launch the Russian market.

As Mr. Manager puts it: “During the Soviet time air transportations were used by 148 millions of passengers. Now on the local market there are only 38 million. Thus, the difference amounts to 110 millions – these people have been lost for airline industry, and this is the audience we consider to attract. Business plan of Sky Express provides that within 5 years we will grow up to 7 millions of passengers. However these 7 millions is a drop in the sea against those 110

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millions. The market is quiet enough for everyone and consequently we are not afraid of the competition”. “We do not have direct competitors. We have our own niche on the local market.”

On the issue about potential entrants Mrs. Manager claims that they have lots of work and there is no time to trace the plans of others. “We are sure that the market is enough for everyone”.

When a new airline carrier with the low prices for tickets launches the market, it is favourably not for all traditional airlines. If they met any counteractions to the plans of Sky Express and when colliding with misunderstanding from some airports and their base airlines, they tried to explain their main goal: they initially came to work with other passenger segment. The company does not want to make the market smaller. “We try to explain that we have essentially different class of passengers, the different approach to them and the different purposes compared to traditional carriers” (Mrs. Manager).

Lack of the aircrafts leads to the problem of unreliability: being out of date, according to the statistics 20% of flights are delayed and often it is because of the technical troubles and absence of extra aircrafts.

The chief manager of one traditional airline company says that Sky Express are succeeded in escaping number of problems because the project is guided by the CEO of KrasAir, to which civil servants are quiet loyal. These lobbyist opportunities contribute to the promotion of Sky Express in regions.

Problem of e-ticket is recognized as the one of interest at this time. E-ticket is innovative system of selling tickets. In the whole concept some changes were introduced and Sky Express offers the opportunity to pay not only with the credit cards but with cash transfer through bank or post departments and get the cash register receipt in the bank. In addition, passengers can still buy tickets through the call centres and travel agents. None of international airline company uses such methods. However, CEO of Sky Express Marina Bukalova, in the interview to the journal “Dengi”<sup>14</sup> says that she “does not understand the pessimism of my colleagues”. The company had a number of consultations with the Department of Transportation and “all the points at issue are considered and solved” (Bukalova).

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<sup>14</sup> “Dengi” no. 4, 2006, p.26

Recently the president of Russia talked that the aircrafts of more than 1 year would not be imported because of the security and safety measures. However, the average age of the Sky Express aircrafts is 12 years. Marina Bukalova comments this fact as a sticking point because duties on entry are very high: “As long as the government keep on this level, importing of new aircrafts is unprofitable”.

## **PERSPECTIVES ON LOW-COST AIRLINES IN RUSSIA**

There is no general opinion about the development of low-cost airlines in Russia. Decision of launching the Russian market with the cost leader strategy should be considered very carefully by the company itself basing on its purposes, ways of achievements, available resources. Moreover, special attention should be paid to the market conditions, economic and political factors

Current situation presents that Russian airline market is 8-10 years behind developed countries. Nevertheless, it is very relevant and has peculiarities influenced by Russian history. According to the expert’s opinion, the low-cost carrier can meet some obstacles on Russian market. In the nearest future the number of such airlines is supposed to increase.

### **Bahtin A. and Rybak B. – experts opinions**

Information is taken from the secondary and primary sources: interview conducted with Mr. Bahtin A. and published interview “Russian low-cost projects are quiet realistic” with Mr. Rybak B. from the newspaper “Kommersant”.

#### **1. Why companies choose the strategy of low-cost, their purposes and expected results;**

By the words of Mr. Bahtin the main purpose of low-cost airlines in Russia is to attract a new segment of customers on the local market. “For the last decade only people with high income could afford themselves to travel by plane within the country”.

There is an opinion that crisis in the aviation industry led to appearance of low-cost in Russia. However, Mr. Rybak claims that it is not like that, and that low-cost model on the Russian market goes parallel with the model of traditional airlines. He affirms that Russian airline market has already developed and created conditions to the appearance of low-cost airlines. “I don’t see any crucial differences from compared to other developed countries.”

## **2. Problems and benefits of low-cost airlines on the Russian market;**

Both experts emphasize that appearance of low-cost airlines in Russia has number of advantages on local market:

- The project is a socially important and significant. About 99% of Russian population cannot afford to fly because of high tariffs. Nevertheless, with the development of low cost carriers it would be possible to return a great number of passengers, which was lost during the last 10 years.
- Healthy competition will grow and contribute to the greater consumer choice

Whereas some problems are still hardly unsolved by referring to Mr. Bahtin:

- lack of alternative regional airports with low airport fees for low-cost carriers
- lack of incentives from regional airports
- high import duties on the airplanes
- technological problems, concerning e-ticket system
- mentality of Russian people

Mr. Bahtin separated the problem of mentality of Russian people and stereotypes. First moment is a “power of habits” of those who are used to travel by train, considering the air transport are for the rich people. Another important moment is that low prices associates with the low quality and insecurity. If looking at the forums where people intercommunicate about service of Sky Express, there are number of people mostly dissatisfied by delays and big difference in ticket prices. Also there traced some sceptical opinions about future activities of Sky Express in Russia.

## **3. Perspectives, peculiarities and challenges of low cost airlines on the Russian market**

According the opinion of Mr. Bahtin, there are no general rules of the successful business of the low cost airlines on the Russian market. This question of success or not depends on the company itself basing on its purposes, ways of achievements, planning and available resources. As he mentioned, necessary initial investments amount to 50-100 millions of dollars during two first years.

He paid a special attention to the economic growth with new potential consumers and their additional demand. The concept for a new way for Russia of doing airline business consists in the formation of new transport flow - point-to-point and implementation of new cost technology.

Current situation presents that Russian airline market needs low fares for its consumers, in soviet times there was no need for them. However, historical development of airline industry has peculiarities influenced by monopoly of suppliers. According to Mr. Bahtin's opinion, in the nearest future a good planning and decision-making can increase the passenger flow and attract new entrants to the airline market. Moreover both experts are sure that the business model of Cost leader airline will be successful when low-cost airlines can really compete with the surface transport and can attract passengers of the railways and motor transport.

Sky Express became the first company, which launches the local market. Nevertheless Charter Company "Avialines-400" prepares to be a low-cost airline company; it has already gotten the licenses and certificates to operate on the market as a cost leader company. Another company "Alfa Group" intends to create a low-cost airline company, but they have not applied yet to the licenses. Their first attempt to apply ended with the words of the Head of Press Service of the Department of Transportation that "the requirements for aviation safety are the same for all the market players and no one low-cost company would spare on them"

Airline company Sky Express weighted all the risks and possibilities and with good investments it launches the Russian local market. Both managers of the Sky Express and experts emphasize aspects dictated by the peculiarities of the Russian market. Some points are similar according their opinions but some are varied because of the different judgments and approaches.

## CONTEXT OF THE RESEARCH ON EUROPEAN MARKET

### Liberalization and Low Fares Airline Association

Before discussion about Norwegian Air Shuttle I would like mention some points about European airline market conditions that conducted to the appearance of low-cost carriers in Europe. The first step to make the market free to new entrants was liberalization process of European air transport between 1987 and 1997 and appearance of the European Low Fares Airline Association (ELFAA).

ELFAA appeared in 2004 in response to the success of Southwest Airlines in the US. Low fares model has been the major driver of the successful liberalization process in Europe. ELFAA has 11 airline members from 10 European countries carrying almost 60 million passengers per annum or roughly 16% of intra-European scheduled passengers in 2004, with total low fares services in Europe accounting for approximately 24% (Liberalization of European Air Transport, 2004). The low fares sector has been growing at an average of over 35% per annum over the past 5 years and will continue to grow strongly as the demand for low fares services increases<sup>15</sup>.

Before liberalization the industry was highly regulated and inflexible, with no real competition between national carriers and fares that were set through bilateral agreements between states. A web of bilateral air service agreements shaped the industry, with specified routes and airports, agreed aircraft types, fares and frequencies, and designated carriers. In effect, capacity on the majority of routes was artificially restricted, fares were offensively high and entry into markets by non-flag carrier airlines was virtually impossible. Various European regions left outside agreed route networks due to decisions taken at national level had either no possibility of attracting air services or had to rely on connecting services through the emerging network hubs of the flag carriers. In short, European integration suffered. Liberalization and the appearance of low fares air travel forced the traditional carrier airlines to compete for the first time. Competition has led to lower airfares and better services across the board. As a result air traffic has exploded which was pressed for years due to the lack of competition and high fares. Liberalization has also led to increased competition between airports bringing lower costs and more efficient services. This has greatly improved direct connections between the European regions, leading to increased inward investment, tourism and related employment.

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<sup>15</sup> Information is taken form the official site of ELFAA – [www.elfaa.com](http://www.elfaa.com)



The presence of strong low fare competition in European air transport continues to be crucial at a time when the traditional network carriers are consolidating and as a result continue to withdraw direct services from regional airports and continue to charge higher fares. A lack of understanding by decision-makers of changes in the industry will lead to the continuation of “ill-informed and incoherent policies” (Handbook of Airline Economics, 1995) which undermine the low fares model, leading to less competition, higher fares for consumers, and less services to the regions and major city routes. By opinions of the experts, these all will seriously undermine European integration and economic development.

Thus the purpose of the ELFAA is “to ensure that European policy and legislation promote free and equal competition to enable the continued growth and development of low fares into the future, allowing a greater number of people to travel by air.” (<http://www.elfaa.com/background.htm>)

According to their mission, stated on the web site of ELFAA, this will be achieved by:

- identifying policy areas affecting the low fares sector;
- effectively influencing regulatory issues;
- promoting the common interests of its members in the various European institutions

## **Norwegian Market**

Norwegian authorities have authorized the relaxation of market entry and certification of regional carriers to meet the travel demands of the country's smaller communities. The Norwegian national assembly passed a bill that specified principles for awarding traffic rights to domestic air carriers in 1986. However, national and international commitments limited the government's action regarding the scope of liberalization.

Impact of liberalization had two different patterns of effects<sup>16</sup>:

1. The emergence of a new line of service within the Norwegian airline industry consisting of non-subsidized, short-and medium-haul, intra-and interregional airlines and the establishment of regular route services in several small communities.

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<sup>16</sup> “Liberalization of market entry for Norwegian regional airlines”, Ludvigsen, Johanna. Transportation Journal. Lock Haven: Summer 1993

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## 2. The investment in upgrading of short-field airports in two small communities.

Before 1994 the Norwegian domestic market was regulated, and the routes had been split between Braathens S.A.F.E and SAS. However, in 1994 the market was opened for competition. The first low-cost airline company Color Air launches the local market in 1998 and operated between Fornebu Airport, Oslo and Ålesund Airport, Vigra. On October 8, 1998 the new Oslo Airport, Gardermoen opened, replacing Fornebu. This eliminated the bottleneck in Norwegian aviation, and Color Air used this new capacity to also start domestic flights to Bergen Airport, Flesland, Stavanger Airport, Sola and Trondheim Airport, Værnes with five Boeing 737-300s. SAS met this competition by also introducing flights to Ålesund, while both SAS and Braathens increased the number of departures to all involved cities, exceeding 50 daily flights each way to each city. All three main city routes were among the ten domestic routes in Europe with the most seats ([http://en.wikipedia.org/wiki/Color\\_Air](http://en.wikipedia.org/wiki/Color_Air)).

The considerably lower prices that Color Air offered resulted in a price war between the three airlines. Though the other two airlines also offered low-fare tickets, these were often issued with restrictions concerning travel dates and refunds. However, Color Air failed to win the business market. In addition, both SAS and Braathens had liquidity to lose vast amounts of money on the war; SAS could subsidize its routes from profits made domestically in Sweden and Denmark and from its international routes while Braathens had lots of cash and KLM as a major owner at the time.

In 1999 Color Air went bankrupt. It is estimated that the airline lost about half a billion NOK during the 13 months they operated.

The major players in this market include SAS/Braathens, British Airways, Air France, Lufthansa, KLM, Finnair and Sterling. These companies serve both the leisure and business travel markets. At the present there are two low-cost airline companies on European market: Ryanair and EasyJet, both companies fly from Norway to Europe. Norwegian is the only one company operating on domestic market.

Last five years marked with changing customer preferences. More difficult economic conditions and increasing competition across most corporate sectors have made both employers and the travelling public in general more price-sensitive. Passengers are generally less willing to pay higher prices in return for on-board food and drinks and other services, moreover on-board food

and beverage service is less important on shorter routes. On longer routes the availability of greater comfort and a high degree of on-board service is more important in relative terms, while on shorter routes passengers are more concerned with a point-to-point service at the lowest possible price.

Another point I want to emphasize that there are significant changes in the Internet sales of tickets. This is particularly true for the leisure and vacation travel market, and business travel has also shown a trend for increased use of internet booking. Statistics for Norway shows that 77% of the population in the age group 16-54 use the internet at least once a week (source: Statistics Norway).

## **ABOUT NORWEGIAN AIR SHUTTLE AS**

Information about the Norwegian is taken from the secondary sources, basically from the official site – [www.norwegian.no](http://www.norwegian.no) and its annual reports and other documents and prospectuses, concerning activities of the company.

Norwegian Air Shuttle is a Norwegian low-cost airline, with headquarters at Fornebu outside the country's capital Oslo and its main base at Oslo Airport, Gardermoen. Norwegian Air Shuttle is also referred to as Norwegian, which is the company's commercial brand. Since the domestic market in Norway is one of the largest air travel markets in the Nordic region, in 2002 Norwegian established a new position in its domestic market alongside SAS. Norwegian decided to start low-price operations in the local market of Norway. After cancellation offered on the domestic market frequent flyer bonus arrangements, the company took the strong position as the cost leader airlines. The first scheduled flight took off on time on Sunday 1 September 2002.

Since 1993 the company used Fokker 50s on western routs. This operation was terminated in 2003, but continued flying regional routes in the north of Norway. However, since their strategy is to focus on low-cost flights using Boeing 737 aircraft, the Fokker 50 operation was terminated at all December 31, 2003. In the beginning Norwegian signed long-term lease contracts for six aircrafts Boeing 737-300. In 2005 total aircraft in the fleet in that period have increased to 14 Boeing 737-300. By the start of 2007, Norwegian has 24 aircraft of Boeing 737-300 with 148 seats. Its operational centres are in Oslo and Bergen and its technical centre is at Stavanger Airport, Sola. The average age of the fleet is 11 years.

The concept for this operation from the very start was to make the distribution of tickets as accessible, simple and cheap as possible. The Company placed great importance on ensuring that tickets would be available through all the main distribution channels of travel agents, call centres and the internet.

The main factors in the development of Norwegian's route network had been to:

- Participate in the sizeable point-to-point market from/to Oslo that has been either overpriced or under-served
- Be the first low-price company on routes so far only served by established players
- Develop smaller markets by introducing the low-price concept
- Ensure that the company's offer is attractive to both leisure and business travellers
- Ensure maximum overall utilization of the aircraft fleet in order to achieve lower per seat operating costs
- Continuously adapt the company's offer in response to both short-term and long-term changes in the pattern of demand

Norwegian is a member of ELFAA. Among the largest low fares airlines in Europe Norwegian is on the 4<sup>th</sup> place<sup>17</sup>.

## **Destinations**

The company has operated routes between destinations in western Norway since 1993. The Company started on the four destinations in Norway: from Oslo to Stavanger, Bergen, Trondheim and Tromsø. After the first month of operations Norwegian had built up a market share of between 10% and 15% on the individual start-up routes. Towards 2003 Norwegian developed its network to comprise 17 routes: 12 in Norway and five from Norway to foreign destinations. In the first half of 2003 four new domestic routes were opened: Oslo-Bodø, Oslo-Evenes, Oslo-Molde and Trondheim-Tromsø. The second half of 2003 saw the start of further new routes: Oslo-Ålesund, Oslo-Alta, Bergen-Stavanger and Bergen-Trondheim. Norwegian opened routes to holiday destinations in Spain and Portugal (Malaga, Murcia and Faro) towards the end of the 2002/2003 winter season. In June 2003 the Company started flights to London (Stansted) and flights from Oslo to Stockholm started in September 2003. Norwegian developed its route portfolio in 2007 to cover 92 routes – 11 domestic and 81 international.

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<sup>17</sup> Pressekonferanse 23. april 2007

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In 2006 Norwegian Air Shuttle AS transported 5.1 million passengers.

## Strategy

The company operates travel volumes both in the domestic market and for international travel from Norway by using low ticket prices to stimulate market demand. The company defines the following focuses to achieve good profitability from this low-price strategy:

- Safe and cost-efficient operations which consists of several main points:
  - Standardized aircraft fleet
  - Point-to-point, interlining practice (i.e. sharing routes with other airlines, typically leads to delays for passengers and their baggage as well as reducing ticket revenues)
  - Outsourcing service functions (e.g., all passenger-handling functions on the ground.
  - Simple travel concept – no free meals and drinks
- Active revenue management: Norwegian selects the busiest routes since these offer the opportunity to achieve the highest ticket prices. Outside peak times, the Company seeks to make best use of its capacity by flying price-sensitive routes. The Company adapts its route program in response to seasonal variations, holiday periods and vacation times. The Company will operate routes to and from centrally located airports where it can achieve higher ticket prices that more than offset any higher airport costs.
- Use of information technology to automate the business processes involved in the sale and administration of tickets
- Organizational efficiency: the company places particular emphasis on operating with a dynamic decision-making process that allows it to respond quickly and implement necessary changes immediately.

## Company's values

Norwegian as a low-cost airline company pays high attention to punctuality and safety.

### *Punctuality*

The group's punctuality, measured in delays exceeding 15 minutes, has been poor in 2006. The main reasons for delays have normally been technical related, shortage of crew or weather related.

### *Safety*

Concerning safety at no time since Norwegian was incorporated over 10 years ago has it been involved in any accident or incident that caused injury to passengers or crew. Moreover no

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accidents or work injuries have been incurred on the ground that caused any significant personal injury or disability. On their web site Norwegian mentioned that after the 9/11 terrorist attacks on the USA, security measures at Norwegian airports have been intensified. Safety is promoted through training programs that are compulsory for all crewmembers upon recruitment and subsequent tests and qualification requirements. The Company's pilots and its aircraft (Boeing 737-300) are approved for instrument flying in CAT II/IIIA weather conditions (fog) in line with other airlines. This type of approval requires special training and monitoring programs. The Company carries this out as part of the two annual simulator-training sessions that all its pilots must complete.

## **Pricing policy**

Ticket prices are actively managed as a major tool to both increase passenger numbers and optimize the economics of each departure. Other major elements in the Norwegian active approach to revenue management include simpler and fewer advance purchase rules, the use of different ticket types for different categories, demand-driven pricing right up to the point of departure and short-term changes to route schedules.

The Company operates six price categories, with one fully flexible price and five categories of discounted prices. In addition marketing campaign prices are used to improve load factor in periods when demand is expected to be low. The price range for normal ticket prices is between NOK 195-1,895 on domestic routes and NOK 165-2,385 on international routes.

Average ticket prices (yields) were relatively low when operations first started in September 2002 due to introductory offers in the initial phase of sales. Prices of fully flexible tickets were increased in January 2003, giving a higher average ticket price. The average price then remained stable on the high frequency routes in southern Norway until September 2003. In October 2003 a number of factors that affect prices changed. Prices on fully flexible tickets to all destinations were reduced by 10-12% in response to price reductions by competitors. In addition the advance payment rules for high-frequency routes were changed, and ticket types that previously had to be purchased more than three or two weeks prior to departure can now be purchased up to one week before departure. Both these changes led to a fall in average ticket prices in October. The company abolished all advance purchase restrictions for its high-frequency routes with effect from 15 December 2003.

Therefore, the company achieved an improvement in load factor from 51% at the start of operations in September 2002 to 79% in the end of 2006. Average ticket prices on the typical vacation routes vary according to season: prices are high in periods of high demand, but are correspondingly lower in periods of low demand.

## **Company's Costs**

Norwegian has developed its structure and organization based on commitment to maintaining a low cost base<sup>18</sup>. The company costs are largely driven by the following points:

- Increased production
- Single-type aircraft fleet
- Efficient use of the company's personnel: Norwegian strengthens central administration functions, particularly in the areas of accounting, revenue management and financial control. In order to contain salary levels and motivate staff to continue to show strong commitment, the company has introduced measures including a share option program for employees.
- Distribution costs: Approximately 84 % of all bookings in 2006 were made over the Internet, compared to 75 % in 2005. The relative growth has led to a reduction for Norwegian's call-centre to about 2 % of the total volume. The share of travel agency sales has had a decrease. Travel agents sales accounted for 56% of total sales in September 2002 and 35% of sales in September 2003. The company uses the software Amadeus.
- Ground operations and on-board services: Norwegian does not offer meals on its flights, but where flight time exceeds one hour, both food and drinks can be purchased. Tax-free sales are also offered on international routes.

From the starting their policy of low-cost flights the company had net loss from 2002 until 2004, only in 2005 they earn their first profit.

## **PERSPECTIVES ON LOW-COST AIRLINES IN NORWAY**

Norwegian itself marks several aspects of the main potential risks for the company. Since Norwegian only serves Norway as a market, the company's future activities and growth will be affected by the general growth of this market and any increase in competition. Norwegian's growth is dependent on access to the right airports in the geographic markets Norwegian has

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<sup>18</sup> Information is taken from the Prospectus 2003 and Annual Report 2006

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chosen being available at a cost level compatible with the company's low-price strategy. Any developments that might delay, limit or defer Norwegian's access to airports that it already serves or wishes to serve in future will represent obstacles to the company's further growth. Airports may also introduce restrictions such as limitations on operational hours, aircraft noise, use of runways or total numbers of daily departures. Such restrictions may adversely affect Norwegian's ability to offer services or improve its range of services at such airports.

There is intense competition between airlines. Airlines compete principally in terms of ticket price, service frequency, punctuality, safety, brand recognition, passenger loyalty (measures such as regular flyer bonus programs) and other service-related issues. Norwegian competes with a number of other airlines, principally SAS/Braathens on domestic routes and operators including British Airways, Sterling and Ryanair on international routes from Norway, and many of these competitors are larger than Norwegian, have greater resources and enjoy stronger brand recognition. In addition a number of Norwegian's competitors are state-owned or state controlled companies that have historically received subsidies and other state support. Norwegian expects to experience further competition from new and existing low-price companies (including low-price operations set up by major airlines) that will compete in the low price segment on Norwegian's routes.

However according to the opinion of Mrs. Strandenes she does not see strong threats from the new entrant low-cost company, because it would be very hard for new company to launch domestic market, where two companies, Norwegian and SAS, has strong position.

Mrs. Strandenes also emphasized fluctuations in the company's earnings. The company's profitability can vary from quarter to quarter, and the management of Norwegian expects such variations to continue in future. Trends in passenger volumes are closely correlated with general economic conditions. Moreover the air travel market is exposed to fluctuations caused by normal seasonal variations. For example in historic terms January and February have been months of low load factor and this has had an adverse effect on airline revenues and earnings. Other specific events such as aircraft accidents, terror attacks, political uncertainty etc. may also have a major impact on passenger numbers.



Airline company Norwegian operates successfully in the domestic market and develops in international routes. Information taking from secondary sources gave rich description of company's activities, moreover, academic point of view of the expert proved or contests some issues.

## ANALYSIS

*As the purpose of the paper is to investigate peculiarities of the business activity of low-cost airlines in Russian and Norwegian context, the empirical were structured in a way in order to facilitate the comparative analysis of the two cases trying to reveal and explain some differences or to find any similarities between them. Analysis includes both my interpretation of the facts and a certain order of their presentation, data structure, according to the theoretical models.*

### GENERAL ANALYSIS FRAMEWORK

Having studied the theory concerning airlines industry, I can imagine the environment where the airline business is developed, how low cost flights are designed, and what is the role of such competitive strategy in the region development.

For better visualization and understanding of the comparison of two cases it is important to present their analysis in systematic and not complicated form. In order to answer the main question of the Master Thesis, I applied the theory of PESTE analysis in the first part of this chapter to analyze the peculiarities, similarities and differences of the business environment of two companies correspondently in use and kinds of information systems in Russian and Norwegian context. Points that I mentioned when listing advantages and disadvantages will help me to reveal strengths and weaknesses of both companies in the second part.

To answer the problem statement I compare the data collected from two case studies with respect to the analysis of PESTE factors. Defining and highlighting these market factors will help to show peculiarities of each market, similarities and differences in the companies' activities and explain them. After revealing similarities and differences I will give a short the analysis of threats, strengths, weaknesses and opportunities, so called SWOT analysis. The general analysis framework is better illustrated on the picture below (Figure 8).

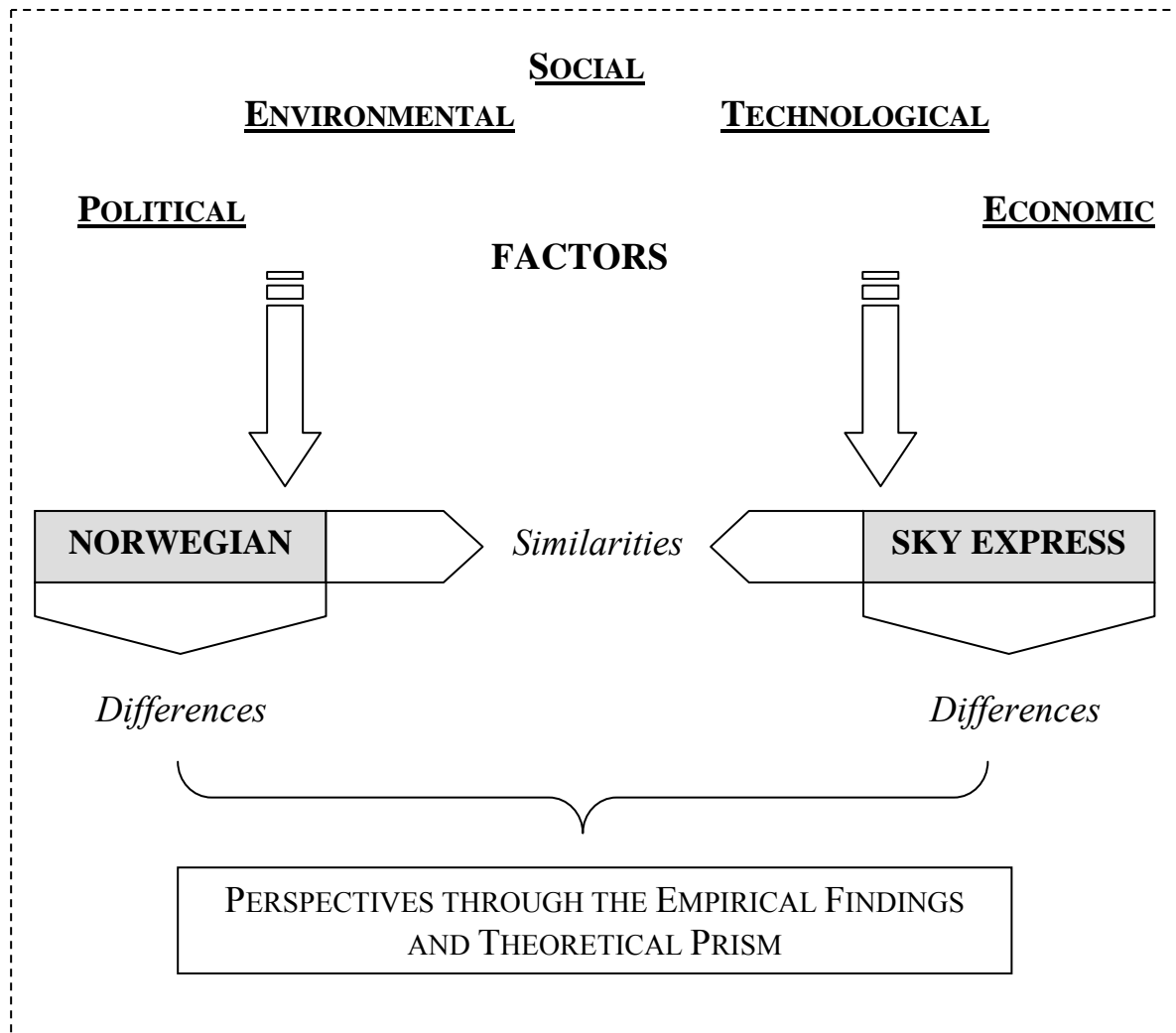


Figure 8: The General Analysis Framework.

## PESTE ANALYSIS

As the empirical data was presented regarding the main aspects by which I make a comparison in this chapter. The results of the analysis with respect to PESTE factors are presented in Table 4 correspondently. I believe it is a good way to find similarities and differences in the companies' decisions.

Table 4. Main PESTE factors, influencing activities of both companies

<b>Factors of PESTE Analysis</b>	<b>Norwegian market</b>	<b>Russian market</b>
<b>POLITICAL</b>	<i>Strong monopoly before Norwegian launched the market</i>	<i>Property redistribution on the airline market and appearance of alliances which began to buy up</i>

	<p><i>Liberalization of domestic market between 1987 and 1997 has its impacts.</i></p> <p><i>The terrorist attacks in the United States on 11 September 2001 caused a further slowdown in economic growth.</i></p> <p><i>Major events in 2003 such as the US invasion of Iraq and the spread of the SARS virus have also had a negative effect on the global economy.</i></p> <p><i>Lobbing from the side of party SV (Social Left) helped to end bonus arrangements on domestic market</i></p>	<p><i>actives of the small companies and established new ones – a so-called industry split.</i></p> <p><i>Corruption in the Department of transportation created additional counteraction and obstacles for new potential entrants</i></p> <p><i>Lobbing from the government helped to get necessary licenses and certificates, because of good relations between officials from Russian Aviation and curators of the project Sky Express (from the words of Mr. Rybak)</i></p> <p><i>Imperfect legislation base concerning e-ticket implementation</i></p> <p><i>After terrorist attacks in 2004 there are still shortcomings in safety control measures, but consequences of terrorist attacks on 11 September 2001 are not that significant</i></p>
<b>ECONOMIC</b>	<p><i>Economic downturn aroused a desire for increased competition and lower prices.</i></p> <p><i>Overcapacity in the aircraft market, leading to good opportunities to negotiate favourable leasing agreements.</i></p>	<p><i>Impetuous increase in prices on aviation fuel in 2005 became the main reason for changes in airline market</i></p> <p><i>Aging of airline fleet made airline companies to lease foreign aircrafts</i></p> <p><i>Import duties are quiet high: including VAT they amount to 40% from the aircraft value</i></p> <p><i>High airport charges with monopoly of fuel suppliers in many cases leads to flight delays and cancellations</i></p> <p><i>Absence of regional airports</i></p>
<b>SOCIAL</b>	<p><i>Changing both leisure and business customer preferences: now time-saving is more important on short-haul routs, people are ready to suffer lack of services</i></p>	<p><i>Low level of mobility because of high prices on tickets</i></p> <p><i>Because of the territory of the country level of mobility needs to be higher</i></p>

<b>TECHNOLOGICAL</b>	<p><i>Increasing use of Internet among not only leisure travellers but also among business segment. Greater use of the internet has made airline ticket prices more transparent, and it has become more difficult for airlines to maintain a differentiated pricing strategy now that travellers can search for the best available prices through the internet.</i></p> <p><i>Video-conferencing has only a limited effect on business air travel, with substitution rates of 2.5–3.5%</i></p>	<p><i>Using internet is “out-of- fashion”</i></p> <p><i>Expensive equipage of airports with electronic check-in desks</i></p>
<b>ENVIRONMENTAL</b>	<p><i>Improvements of environmental performance: reduced the average fleet age amongst ELFAA members to just 3.9 years at 31 December 2006</i></p> <p><i>High seat density and industry-leading load factors result in minimized fuel burn and resultant CO<sub>2</sub> emissions per passenger kilometre<sup>19</sup>.</i></p>	<p><i>From January 2006 tightening of requirements for safety measures</i></p> <p><i>Measures from noise lowering and engine emission</i></p> <p><i>Mentality of Russian people concerning low-prices have negative effect on perception of low-cost airlines</i></p>

## COMPARISON OF TWO CASES: DIFFERENCES AND SIMILARITIES

With the aid of the Table 4 and empirical findings I will make the comparison of two cases and reveal similarities and differences of two companies. I would like to mention that since Norwegian exists a number of years on the market, its goals are rich and formulated very definitely. Many aspects concerning activity of Sky Express are taken from the words of managers and could not be confirmed with the numbers from the respective reports. In parallel with revealing differences and similarities, and thus peculiarities of each market, I will give explanations, reasons and prerequisites.

As is clear from the Table 4 the competitive strategies of the companies were defined by mostly external factors. In case of Norwegian there was an obvious reason and wish to differentiate themselves from SAS (Mrs. Strandenes) and to destroy the monopoly in domestic flights. In case

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<sup>19</sup> Information is taken from the report “Environmental performance of low-cost airlines” by ELFAA

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of Sky Express there is a lack of affordable airline services which could be used by majority of population. That is why the company sets its goal as “to up the mobility of nation”.

In both cases market conditions told that the market was ready for new entrant company, which would offer low-cost operations. Liberalization which gave opportunities for new entrants concerned Norwegian market as a part of European one. Market conditions looked favorable for the company: this period was affected by an economic downturn, and there was a general desire for increased competition and lower prices and at the same time there was overcapacity in the aircraft market, and this created good opportunities to negotiate favorable leasing agreements. Monopoly on the Norwegian market was destroyed after ending bonus arrangements and Norwegian started low-cost operations. In case of Sky Express patronage from the side of the CEO of KrasAir made easier process of establishing a new company. In both cases lobbying played an important role. But in case of Norwegian such measure was for creation favorable market conditions and removal of SAS monopoly. The ending of bonus arrangements on domestic market allows Norwegian to attract those customers who constituted the demand for bonus offers. Lobbying in Russia usually helps to go through the obstacles due to the shortcomings in the necessary laws. Lobbying helped Sky Express to evade gaps in the legislation base that were not ready to innovations such as implementation of e-tickets. One of the main peculiarities of Russian market is an existence of corruption, which creates additional troubles when establishing a new company.

As for destinations, both companies started their operations on local markets. On the basis of established position in the domestic air travel market in Norway, Norwegian decided to expand its activities by opening international routes targeting leisure travel to traditional city and Southern European holiday destinations. This expansion also reflects the need to make greater use of the aircraft fleet. In nearest plans of Sky Express there is no goal to launch international market, because the percentage of “not-flying” people is high.

Unlike many of its European counterparts, Sky Express and Norwegian fly to cities’ main airports. Norwegian chose airport Gardermoen instead of Torp in Sandefjord. When Norwegian entered the market it was more important to attract customers and lure away those who used to fly with SAS, but wished the ticket prices were lower. As Mrs. Strandenes marked Norwegian concentrated on short and fast domestic flights and long 2 hour bus or train trip to airport Torp would pushed away potential consumers. Sky Express chose Vnukovo by the following reasons:

- The first one is an absence of the regional airport ready to serve airlines.

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- Another reason is that this airport has the most advantageous geographical location among all the rest Moscow airports. In particular, Vnukovo is situated in the maximum nearness – 28 km from the center of the city. Airport Vnukovo is very well integrated with the developed network of transportation lanes in the infrastructure of Moscow. Passengers can reach the airport using three highroads. From the last nearest metro station busses and taxis goes to the airport. Also railway main line is connected the center of the city and the airport.
  - Vnukovo is the one Moscow airport which has need for additional passengers and try to increase passenger traffic. At present Vnukovo serves 2,5 mln passenger less than normally. Sky Express which tells that in the end of 2007 number of flights will go up to 60 and airline fleet will amount to 14-16 were very attractive for Vnukovo. These mean that the number of passengers will increase to 1,3 mln people per year (almost the same number of passengers is served by the major airport's airline company UTair).

As potential customers Norwegian paid great attention not only for leisure traveler but also business one (contrary to Color Air which bankrupt partially because of the lack of a loyalty program to attract business customers). The company has successfully generated a positive trend for its sales to the Norwegian business travel market despite the not inconsiderable costs involved in changing customer behavior as a result of entrenched preferences, established travel procedures and the bonus programs offered by competitors for international travel. While Sky Express does not divide their passengers and concentrate on “non-flying population”. But according information on their official web-site they do seek business travellers offering special corporate offers - uniform tariff, possibility to buy tickets 3 hours before departure, non-cash payment vehicle and bonus arrangements. Oleg Panteleev, COE of analytical company Aviaport also shares this opinion. Referring to his words business travellers are the target segment and they compose the base of passenger traffic on the rout Moscow-St. Petersburg which was opened recently. Short flight allows refusing additional services without in the prejudice of their comfort. But the most significant incentive to buy tickets is a comfortable timetable and flight frequency and Norwegian set them competently. Therefore if Sky Express increases number of flights, including morning and evening time, the share of customers will increase. And Norwegian presents good example because the company managed to lure away on their flights considerable share of passenger traffic, including business class consumers. In case of Russia it is important to mention one more peculiarity of Russian market - impact of Russian mentality: stereotype that low prices result in unsatisfactory quality. This is one more challenge that the company has to overcome.

Both companies successfully follow the principles of cost-efficient operations, such as single type of aircraft, point-to-point flights, outsourcing of service functions, short turnarounds and high aircraft utilization, limited on-board services. Focus on a uniform aircraft fleet resulted in lower costs due to simpler maintenance operations, reduced need for spares, and reduced variation in the type of tools equipment and infrastructure as well as a simpler administration. But in such points as active revenue management and use of information technology Norwegian succeed better and it is obvious because technological support and conditions are not that advanced in Russia than in Europe. Hence Russian market is not technologically ready to new services such as e-ticket, equipage of airports with electronic check-in desks. Advanced revenue management of Norwegian resulted in advanced pricing strategy. This means that in principle ticket prices for each flight will be determined by the level of demand right up to departure. The abolition of advance purchase restrictions is expected to make it easier to fill seats since pricing can be used as an effective tool right up to departure. The advance purchase restrictions governed which tickets were available to the public at various times prior to departure. The abolition of advance purchase restrictions will mean that the cheapest tickets, which previously had to be purchased at least three weeks before departure, can now be purchased at any time prior to departure if the flight is not heavily booked. While average ticket prices will continue to fall as result of this change, the company expects an increase in total revenue as result of a more attractive product and higher load factor. In distinction from Sky Express which use quiet simple way of setting ticket price.

Another point of difference is environment aspect. Norwegian being a member of ELFAA and operating not only on domestic market but also carrying out international flights must keep environmental requirements and environmental friendliness are the goal of importance along with the others. Sky Express does not talk lots of about environmental issue, following environmental requirements of the Department of Transportation of Russia.

Vital for any domestic airline's success is a need to address concerns about safety and Norwegian has the safety issue in the main principles and values of the company. Against of Norway Russian domestic flights have suffered a string of tragic accidents in recent years. Yelena Sakhnova, an aviation analyst at investment bank Deutsche UFG, said most Russians traveled by train not just because the trains are relatively cheap, but because they are afraid of flying.



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## **FUTURE PERSPECTIVES THROUGH THE EMPIRICAL FINDINGS AND THEORETICAL PRISM**

The question of future of the cost leader sector is one of the most fascinating in airline industry at the moment. Each market has its peculiarities and talking about future perspectives on the Russian market it is important to remember that the market is imperfect and new entrants have a great impact on the whole airline market unlike in Norway, where airline market has its constant characteristics. Based on theoretical aspects, main tendencies of other low-cost airlines and according to my own empirical findings I can emphasize the following perspectives:

- Demonstration effect: this is the first low cost airline in the Russian Federation and new patterns in the air transport sector are introduced (e-tickets, innovative mode of distribution, new approach to customer service, etc.)
- Improved competitiveness in the air transportation sector: the introduction of a low cost service will further push for consolidation and modernization of the airline industry.
- Market expansion: the introduction of this service will drive the upgrading and expansion of the air transport infrastructure to achieve the required ground service efficiency

According to the empirical part the assumption that sooner or later a number of competitors will join the market is more than realistic on the Russian market. As Sky Express got in there first and did it right, they have to create a recognized and trusted brand based on how well the company treat their customers. Sky Express has to insinuate itself into Russian people confidence.

I can not exclude price wars that could take place in future like it was on Norwegian market. And in this case management of the company has to be very attentively to market sensitivity and have strong position not to lose a war.

Concerning Norwegian domestic market, there still are opportunities. I can assume that domestic market will experience further competition from new and existing low-price companies (including low-price operations set up by major airlines) that will compete in the low price segment on Norwegian's routes.

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Norwegian has grown rapidly since introducing its low-price business model in 2002. This rapid growth has caused a similar growth in the demands placed on the company's management resources, systems and internal control procedures. The management of Norwegian is planning rapid further expansion of the company's activities. This rapid expansion may place such a burden on the company's management resources and on its operational, financial, management and control systems that they may prove insufficient to meet the company's needs, and this may create a need for major investment. Norwegian anticipates that it will need to develop further its financial and management reporting systems and procedures in order to cope with its continuing growth. There can be no certainty that Norwegian will prove able to develop such control systems and procedures in effectively, and any failure to achieve this objective may have a negative impact on the company's operations, earnings and financial condition.

I can also suppose that often SAS strikes will lead to decrease in number of their customers and part of them will move to Norwegian.

Norwegian had a rapid expansion of the company's activities and it will have it in future. As the company goes through a period of rapid development with particular focus on human resources and creativity, Norwegian will be very dependent on key individuals. If such key individuals should choose to leave the employment of Norwegian this could have adverse consequences for the company's future development. Similarly Norwegian's future development will be very dependent on the company's ability to attract and retain skilled personnel and to develop the level of expertise throughout its organization.

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## CONCLUSIONS

*In the Conclusions I highlight and summarize the results of my research and present some ideas for future investigations.*

### SUMMARY OF THE RESEARCH

The purpose of my work was to find out the peculiarities of the development of the low-cost airlines on the examples of two case studies, namely of Russian and Norwegian enterprises.

For today both companies have the following results:

- The traffic and revenue boost resulting from an increase in Norwegian’s operating fleet by six aircraft to 22, along with falling unit costs, were enough to overcome lower yields and help Norwegian narrow its first-quarter loss to NOK14.9 million (\$2.5 million) from NOK42.9 million in the year-ago period.
- Services of Sky Express are in demand and this can be confirmed with the following numbers. During three months of company’s activity on Russian market, Sky Express realized 1060 flights that in sum amount to 2000 flight hours and 5 aircrafts conveyed 78 000 of people. By the words of the CEO Marina Bukalova “the results surpassed all our expectations”.

The success of low-price operators is based on a business model specifically targeted at meeting the needs of passengers who want to travel cheaply, efficiently and safely. Their success has been achieved at the expense of the established players, but has also expanded the overall market by attracting new customers and by markedly increasing the overall volume of leisure travel journeys.

Deep theoretical base helped to imagine how low-cost airlines operates and what are their main benefits for customers, airlines themselves, regions and also reveal disadvantages from their activities.

Interviews with managers and academic point of view helped me to reveal differences and similarities between two companies and then moved to the discussion of perspectives of two companies. The research showed that the Russian market is imperfect and when launching the market it is very important to have strong support to overcome gaps in legislation base. Also new low-cost entrant meets obstacles connecting with technological imperfection and mentality of

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Russian people. In case of Norwegian, the company had the main barrier in form of monopoly on the airline market, which was finished with the help of government law. In the developed country implementation of low-cost peculiarities were easier and the company has rapid development not only on the domestic but also on the international market. And now Norwegian is considered to be mature player on the airline market with expanded and well defined goals.

Concerning perspectives of low-cost airline business in Russia low-cost airlines companies have a very strong demonstrative effect and push up to further rapid development of the airline market in the whole, while main Norwegian low-cost airline expand its activities on the international market and improved cost-efficient operations on domestic market.

In whole, the analysis of data collected through the interviews and literature review, as well as the implementation of relevant theories for analysis results' explanations, contribute to better understanding of the phenomenon connected with the operations of low-cost airlines regarding the context of two markets.

## **SUGGESTIONS FOR FURTHER INVESTIGATION**

As it was showed in my research low-cost market is very dynamic and has high potential for growth. Under these circumstances, I consider future researches in the following directions will be very interesting and relevant:

- Development of low-cost airline companies.
- Techniques of entering the Russian market of low-cost airlines and their actions.
- Influence of low-cost airlines activity on the market players.
- Comparison of low-cost strategy dynamic in Russia and other countries
- Low-cost carriers on the sea market.

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## APPENDICES

### APPENDIX 1. INTERVIEW GUIDE IN RUSSIAN.

Цель данного опроса – изучение феномена существования бюджетных авиалиний, опираясь на опыт уже существующих low-cost авиалиний, в данном случае норвежской компании Norwegian, и только что появившейся на российском рынке первой low-cost компании Sky Express. Опираясь на ряд теоретических работ и предшествующих исследований, я бы хотела посвятить нашу беседу вопросам, указанным ниже. Более того, я уверена, что значительный опыт работы позволит Вам выделить аспекты, которых в указанном списке Вы не найдете, но которые, по Вашему мнению, имеют для Вашей компании большое значение, и поэтому буду рада проявлению Вами инициативы в этом направлении.

#### *Рынок и потребители:*

- Основная политика Sky Express?
- Каковы черты, характеристики, предпосылки российского рынка позволили компании выйти на него?
- Какие клиенты являются целевыми для Вашей компании? Как этот выбор влияет на линейку предоставляемых услуг?
- Какие трудности испытывала компания при выходе на рынок? Какие удалось разрешить и как? Какие нет и почему?

#### *Аэропорт:*

- По каким критериям выбор аэропорта пал на Внуково?
- Проблемы «нерегионального» аэропорта.

#### *Стоимость и качество услуг и экономия:*

- Каким образом обеспечивается должный уровень качества предоставляемых Вашими авиалиниями услуг?
- Какие показатели берутся за ориентир при определении приемлемого уровня качества?
- Как бы Вы описали механизм определения стоимости услуг в Вашей фирме?
- Каким образом при этом решается проблема соотношения цены и качества?

#### *Проблемы и прогнозы:*

- Какие трудности испытывает компания в настоящий момент? Как меры предпринимаются для их решения?
- Какие риски для компании Вы можете выделить?
- Проблемы «экономии» и
- Проблемы специфики и «неподготовки» российского рынка (заказ билетов on-line, электронный билет, etc.)
- Прогнозы и планы на ближайшее будущее.

Спасибо за сотрудничество!

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## APPENDIX 2. INTERVIEW GUIDE IN ENGLISH.

This research is devoted to the investigation of the phenomenon of low-cost airlines. I would like to base my research on the existing low-cost carrier's experience – Norwegian Air Shuttle ASA, and the first Russian low-cost airline SkyExpress, which has recently started its operations on the local market. Having my own perspective based on a number of theoretical studies and previous researches, I would like to devote our conversation to the questions listed below. However, I am confident that the wide experience of operations in Norway and internationally will allow you to raise some issues, which are of special relevance in your own unique case and were not mentioned in my list. Thus, you are welcome to include any additional aspects to the list below.

### *Market and customers:*

- What was the reasons to take the strategy of a low-cost carrier?
- What were the main particularities of the market that were relevant for the company when it was decided to take the strategy of low-cost?
- What kind of challenges did the company face during the launching period? What challenges did Norwegian manage and how at that time? What problems remain unsolved?

### *Airport:*

- As far as I am concerned the airline operates exceptionally in the main airports of the Norwegian cities. How can you explain the choice of Norwegian in favor of Gardermoen, and not Torp, Sandefjord mostly used by Ryan Air?
- What benefits of regional airport did the company suffered and what benefits was not that significant for the company?

### *Problems and forecasts:*

- Does the company suffer any troubles now? Does the company have any risks? If it does, then can you emphasize them?
- What are the plans and forecasts for the future development of low-cost in Norway?

Thank you for your cooperation!