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Ryanair: Dogfight over Europe (A)

In April, 1986, the upstart Irish airline Ryanair announced that it would soon commence service between Dublin and London. For nearly a year, the new airline had operated a 14-seat turboprop between Waterford, in the southeast of Ireland, and Gatwick Airport on the outskirts of London. The founders of Ryanair, brothers Cathal and Declan Ryan, felt that service on that first route had developed well. They knew, however, that the Dublin-London route would pose new challenges. For the first time, they would face Aer Lingus, British Airways, and other established competitors on a major route.

European Aviation

The environment in which the Ryan brothers launched their fledgling carrier had long been shaped by Europe's national governments.[1] Privately owned, commercial airlines sprang up in Europe following World War I. Soon, however, the governments of Britain, France, Germany, and other countries began to amalgamate the first, small airlines into national "flag carriers." Each of these airlines literally carried the flag of its nation on the tails of its aircraft. Figuratively also, each airline carried the flag, serving as an international emissary. Predecessors of British Airways, Air France, Lufthansa, and others gradually became owned by, and subsidized by, their national governments. The route structures of British, French, Dutch, and Belgian flag carriers developed to serve the colonial aims of their respective governments. For instance, the aircraft of British Airways' predecessor, the aptly named Imperial Airways, were familiar sights in India, South Africa, Australia, and other British outposts by the 1930s.[2] Service focused on international routes from each nation's capital to colonies, other areas of national influence, and the capitals of other European countries. Intra-country service was sparse, largely connecting provincial cities to the capital. Fares on domestic routes were often kept high to subsidize international service.

World War II brought advances in aviation that made air travel widely economical for the first time. The aftermath of the war also brought the threat of American dominance in air travel. Had free competition been permitted on international routes, the efficient, privately owned carriers of the United States would likely have won the lion's share of the market.[3] A set of multilateral and bilateral agreements averted this outcome. The International Air Traffic Association (IATA), essentially a government-endorsed cartel of the major airlines, emerged to set international fares. Governments negotiated bilateral agreements that regulated all aspects of air travel between pairs of countries. In

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Europe, "pooling arrangements" became common. Under pooling, the routes between, say, France and Italy would be given strictly to Air France and Alitalia. The two flag carriers would pool their capacity and revenue, then divide the proceeds in an agreed-upon manner. Carriers were banned from flights that did not begin or terminate on their national soil; Air France, for instance, could not fly from Rome to Frankfurt or Milan. Intra-country service was also regulated strictly. To varying degrees, domestic fares were set by government authorities, and entry by new airlines was discouraged.

The collapse of European empires and the advent of jets capable of crossing the Atlantic economically led virtually all European flag carriers to refocus their international efforts on routes across the North Atlantic in the late 1950s. Heavy and growing demand for transportation to and from North America made such routes highly profitable, at least initially.

Europe's system of regulation soon came under pressure. A late-1950s attempt to unify the flag carriers of France, West Germany, Belgium, and Italy collapsed under the weight of disparate national interests. By 1960, the *Economist* magazine bemoaned the state of the heavily regulated, fragmented airline industry. "The basic trouble," it concluded, "remains that the world has too many airlines, most of them inefficient, undercapitalised and unprofitable."[4] Though the IATA introduced some forms of restricted, discount fares in the 1950s, consumers grew dissatisfied with high prices. European regulations applied largely to regularly scheduled service between destinations. To bypass these regulations and to tap pent-up demand for leisure travel, charter airlines appeared and grew rapidly during the 1960s. These start-ups, funded in part by shipping companies, offered holiday makers cheap fares on non-scheduled flights and "inclusive tours" that bundled flights with lodging. Charter holidays proved especially popular among British and Irish vacationers, who used them to escape the North Sea for sunnier climes. By the mid-1980s, charter flights would transport 60% of all European passengers.[5] Flag carriers responded to the independent charter airlines both by establishing new discounts within the IATA structure and by starting charter subsidiaries themselves.

The 1970s took airlines around the world into financial straits (**Exhibit 1**). The introduction of wide-bodied aircraft such as the Boeing 747 increased capacity on the North Atlantic route dramatically. The OPEC oil embargo raised the price of jet fuel, and the ensuing recession cut demand for air travel. These events hit Europe's flag carriers, with their heavily unionized staffs and high fixed costs, especially hard. **Exhibit 2** compares the staff productivity of European and U.S. airlines in 1978.

In 1978, the U.S. Congress approved the thorough deregulation of the domestic U.S. airline industry. Pricing, route scheduling, entry, and exit were freed up dramatically. Prices plunged rapidly as airlines competed vigorously for marginal customers. Twenty-two new, low-cost carriers entered the market between 1978 and 1980.[6] Most of the new airlines soon failed, however. Established players such as American, United, and Delta used hub-and-spoke route structures and computerized reservation systems to spur a new wave of consolidation. Following consolidation, prices and profitability remained low and unstable. Strong U.S. airlines reached out for new routes into Europe.

The U.S. experience brought calls for European deregulation from consumer advocates and supporters of competition. A 1984 memorandum from the European Commission proposed the abolition of pooling arrangements, price fixing, and government subsidies. Trade unions and flag carriers allied to defeat the proposal. In 1986, the Single European Act called for the creation of a unified European market by the end of 1992. The market was intended to "comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured…."[7] Industry observers expected new proposals for the liberalization of the European airline industry to follow.

British Aviation and British Airways

While Europe as a whole remained dominated by state-owned carriers with government-mandated monopolies or near-monopolies, individual countries moved to liberalize their domestic airline industries and to push for international deregulation on a bilateral basis with individual countries.[8] The United Kingdom was among the most aggressive in doing so. As early as 1971, Britain's airline regulator, the Civil Aviation Authority, encouraged the establishment of British Caledonian Airways (BCal) as a "second force" to compete with the dominant, state-owned British Airways (BA). Labor Party governments, however, subsequently protected BA from BCal's incursions. Though independent airlines such as BCal and British Midland operated in the U.K. during this period, momentum for airline deregulation picked up only after the election of the Conservative, market-minded Prime Minister Margaret Thatcher in 1979. An early Thatcher bill required, for the first time, that regulators give the interests of consumers equal weight to the interests of operators when allocating licenses for new routes.

A hallmark of Thatcher's government was the privatization of state-owned enterprises, and a centerpiece of her privatization programme was a proposed flotation of BA on the stock market. The state of BA in 1979, however, precluded a rapid privatization. The cost structure of BA and its predecessors had been high at least since the end of World War II, when the flag carrier was expected to "find a job for every demobilized member of the [Royal Air Force]."[9] In 1977, the U.S. carrier Delta transported 30.7 million passengers with 31,000 employees while BA's staff of 54,300 moved 14.5 million passengers.[10] After thin profits in the late 1970s, BA suffered a loss of UK£102 million on revenue of UK£1,760 million in 1981.

A new chairman, John King—a self-made millionaire with experience in the ball-bearing industry—was brought in to revive BA and prepare it for privatization. With generous severance packages, King reduced BA's staff to 38,000 by 1985. Loss-making routes were surrendered to competitors, and maintenance stations and training colleges were shuttered. King soon yielded the reins to Colin Marshall, a former executive of car rental agency Avis, who began to improve customer service. Marshall paid particular attention to satisfying full-fare business customers. By 1984, BA was earning record profits (**Exhibit 3**), and its privatization was being planned for 1987. Deregulation slowed during the period of BA's turnaround. A Civil Aviation Authority proposal to shift some of BA's routes to BCal, for instance, was defeated in 1984, largely because the Treasury Ministry opposed the plan.

In 1986, BA operated one of the world's most extensive airline route networks, serving 145 destinations in 68 countries.[11] No airline carried more international passengers. International journeys accounted for roughly two-thirds of the seats that BA sold and nine-tenths of its revenue. Nearly 80% of passengers passed through London's main airport at Heathrow, one of the world's busiest transportation hubs. Plying the network was a fleet of 163 aircraft, ranging from 44-seat turboprops to Boeing 747s with room for nearly 400. Since 1980, BA had invested roughly UK£700 million to purchase 55 new aircraft, mostly for service within Europe. The company was beginning to upgrade its intercontinental fleet.

In the United Kingdom and New York, BA provided its own passenger and ground services (e.g., for passenger check-in, baggage handling, and aircraft cleaning). Elsewhere, it hired contractors to perform such services. BA catered its own flights from Heathrow, but contracted out all other catering. The company performed most of its own maintenance from a base at Heathrow and had engineering capabilities at three-quarters of the airports it served.

BA sold tickets over the telephone and in 171 retail shops worldwide, where agents also sold package vacations. In addition, 49,000 independent travel agents had the ability to book tickets on BA via computerized reservation systems, including BA's own system. Such agents accounted for 83% of the company's scheduled passenger revenue. BA pitched its services to a wide range of business and leisure travelers. Accordingly, it offered a spectrum of ticket prices with varying restrictions and the full range of classes of service—from first class to economy. Especially among business travelers, BA was known for its improving in-flight amenities.

Irish Aviation and Aer Lingus

As a country with a small population, limited land mass (roughly 250 kilometers across and 400 long), and no colonial possessions, Ireland did not lend itself naturally to commercial aviation.[12] Yet in 1936, a mere 15 years after Ireland's initial political separation from Britain and 13 years before full independence, government and private interests in Ireland came together to form Aer Lingus, a flag carrier for the emerging state. Government support proved crucial in the airline's early days. Annual losses in the 1930s and 1940s commonly ran between 20% and 100% of revenue. Not until the early 1950s did the airline earn a profit in consecutive years, and then only for a short period.

Early on, passenger traffic focused on routes between Ireland and Britain, where a large population of Irish emigrants resided. To develop these routes, the Irish and British governments struck an unusual arrangement in 1946. Through BA's predecessors, the British government took a 40% stake in Aer Lingus, leaving 60% in the hands of Ireland. Aer Lingus was granted monopoly rights to routes over the Irish Sea. BA's predecessors gained the valuable right to land at Shannon Airport on Ireland's west coast, refuel, and continue on across the Atlantic. (Aircraft ranges at the time required such a refueling stop.) In exchange, Aer Lingus was allowed to land in Manchester, take on passengers, and continue to continental Europe. Such "onward rights" were rare in Europe and marked the beginning of relatively liberal bilateral agreements between Britain and Ireland.

The British partnership continued for a decade until Aer Lingus' desire to develop its own trans-Atlantic routes, to reach the large ethnic Irish populations in New York and Boston, created a rift. Amicably, the British government reduced and eventually relinquished its stake in Aer Lingus. The predecessors of BA and independent carriers such as British Midland began to fly routes between Britain and Ireland.

Problems on the North Atlantic corridor in the 1970s hit Aer Lingus especially hard. Compared to other carriers on the route, Aer Lingus drew its passengers especially heavily from the ranks of tourists. Tourist passengers actively sought promotional fares, created erratic peaks of seasonal demand, and largely stayed at home during the recession of the mid-1970s. The Irish government insisted that Aer Lingus continue to fly the North Atlantic corridor despite losses on the route.[13]

Aer Lingus first published its objectives in 1971 and had, by 1986, reviewed and ratified the statement a number of times. The statement called on Aer Lingus to provide an air transport service that was "safe, efficient, reliable, and profitable." The airline touted the many benefits it brought to the Irish community: national development, promotion of tourism, employment, a contribution to the balance of payments, and educational, social, and cultural services.[14]

Losses in the 1970s prompted Aer Lingus to seek new sources of revenue and profit. "We perceived that an airline with a limited home market, limited financial resources and a cyclical product would have to diversify," reflected one of Aer Lingus' chief executives.[15] Aer Lingus began to offer maintenance service and engineer training to other airlines. Successful introduction of its computer reservation system led Aer Lingus to offer computer consulting and data processing services. The company also entered the hotel business in London, Paris, and New England. By 1986, so-called ancillary businesses include hospital management in Baghdad and an investment in robotics.

In 1984-85, air transportation, airline-related services such as maintenance, and non-airline businesses provided Aer Lingus operating profits of 0.5 million Irish pounds (I£), I£12.7 million, and I£17.1 million, respectively.[16] Within air transportation, Aer Lingus' domestic and European routes earned a modest operating profit while its trans-Atlantic flights sustained operating losses for the sixth time in seven years.[17] During the coming decade, Aer Lingus faced tens of millions of pounds of investment to replace aging jets in its fleet. Government officials were contemplating the sale of part of the company to finance the capital expenditures.

Ryanair

Cathal and Declan Ryan had essentially grown up in the airline industry.[18] Their father, Tony Ryan, had long worked for Aer Lingus. As the flag carrier's aircraft leasing manager, the elder Ryan struck innovative deals to lease excess capacity to other airlines. From 1973 to 1975, for instance, he arranged for an Aer Lingus 747 and its Irish crew to ply Air Siam's route between Bangkok and Los Angeles.[19] In 1975, Tony Ryan co-founded Guinness Peat Aviation, which quickly became the largest aircraft leasing company in the world. Tony Ryan's 10% stake in Guinness Peat Aviation gave him sufficient wealth to invest a million Irish pounds in his sons' efforts to launch an airline.

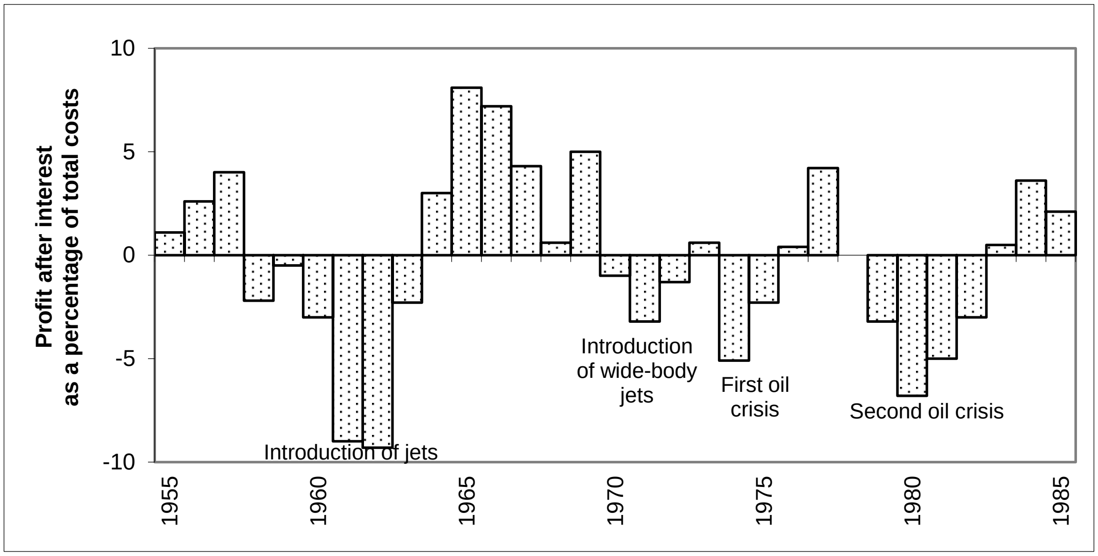
Both sons were in their 20s when Ryanair initiated service in 1985. At first, Ryanair used a 14-seat turboprop aircraft to run a scheduled service between Waterford in the southeast of Ireland and Gatwick Airport, one of London's secondary airports. This initial service was intended to prove the company's ability to operate a scheduled airline successfully. In 1986, Ryanair gained a license to operate between Dublin and Luton, another of London's secondary airports.

Aer Lingus and BA already operated on the Dublin-London route, which was reputed to be quite lucrative for both carriers. Indeed, Aer Lingus' Chairman noted that "Dublin-London is the only route on the Aer Lingus network that has the volume of business to allow of itself a reasonable return on capital."[20] Aer Lingus' and BA's least expensive, unrestricted round-trip fares on the route were priced at I£208 (equivalent to UK£189 at the time). Discount fares as low as I£99 were available, though they had to be booked one month in advance. Observers felt that the figures shown in **Exhibit 4** were typical of Aer Lingus' and BA's average revenues and costs for a Dublin-London round trip.

Ryanair managers believed that the flights of Aer Lingus and BA were typically 60-70% full. According to airport authorities, half a million round-trip passengers flew the route each year. The number of air passengers on the route had been stagnant for ten years. Roughly three-quarters of a million round-trip travelers used rail and sea ferries rather than aircraft. The journey took nine hours by rail and ferry and one hour by air. Prices of round-trip rail-and-ferry tickets fell as low as I£55.[21]

On their new Dublin-London service, the Ryan brothers intended to run four round trips per day with a 44-seat turboprop. They did not have permission to fly larger jet aircraft on the route, but hoped to get permission soon. Ryanair would offer meals and amenities comparable to what Aer Lingus and British Airways provided. The company would distinguish itself from the flag carriers in two ways. First, its employees would focus intently on delivering first-rate customer service. Second, the company would charge a simple, single fare for a ticket with no restrictions. In announcing its Dublin-London service, Ryanair publicized a round-trip fare of I£98.

Exhibit 1 Composite Profitability of All Major, Scheduled European Airlines



Source: Association of European Airlines, 1994 Yearbook, p. 19.

Exhibit 2 Staff Productivity of U.S. and European Airlines, 1978

Airline	Staff	Passengers per staff member	Staff per aircraft
U.S. carriers:			
American	40,134	762	158
Eastern	35,899	1,099	156
Pan American	26,964	358	355
TWA	36,549	665	156
United	52,065	657	156
European carriers:			
Air France	32,173	333	314
Alitalia	17,040	374	279
British Airways	54,645	308	264
KLM	17,812	231	326
Lufthansa	29,400	460	320

Source: *House of Lords Select Committee on European Air Fares,* 1981, 185-7, European Air Fares, Air Transport Users Committee, Civil Aviation Authority, 1978. Cited in P. Lyth and H. Dienel, "Introduction" in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), p. 8.

Exhibit 3 British Airways Performance, 1977-85

	1977	1979	1981	1983	1985
Revenue (mm UK£)	1,073.9	1,403.3	1,760	2,051	2,905
Operating profit before taxes and interest (mm UK£)	95.8	76.0	(102)	169	292
Passengers (mm)	14.5	15.8	17.0	16.3	18.4
Staff (thousands)	54.3	55.9	53.6	45.9	38.1
Available ton-kilometers (mm)	6,233	7,164	7,930	7,208	7,837
Ton-kilometers used (mm)	3,607	4,416	4,812	4,461	5,267
Load[a] (%)	58	62	61	62	67

Source: British Airways Annual Reports. Cited in P. Lyth, "Chosen Instruments: The Evolution of British Airways" in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), pp. 72, 74.

[a] Load = portion of available ton-kilometers used, a measure of capacity utilization.

Exhibit 4 Estimated Revenue and Cost per Passenger, Dublin-London, 1986

	I£	Percent of Revenue
Revenue	166.5	100.0%
Operating expenses		
Staff	35.7	21.4%
Depreciation & amortization	8.6	5.1%
Fuel & oil	31.8	19.1%
Engineering and other aircraft costs	9.8	5.9%
Selling	18.0	10.8%
Aircraft operating leases	3.4	2.0%
Landing fees and en route charges	11.7	7.0%
Handling charges, catering, & other	16.6	10.0%
Accommodation, ground equipment & other	19.5	11.7%
Subtotal	155.1	93.1%
Operating profit	11.4	6.9%

Source: Casewriter calculations, based on British Airways Prospectus, February 11, 1987.

Endnotes

[1] This section draws especially on P. Lyth and H. Dienel, "Introduction," in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), pp. 1-17.

[2] P. Lyth, "Chosen Instruments: The Evolution of British Airways," in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), p. 50.

[3] P. Lyth and H. Dienel, "Introduction," in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), p. 3.

[4] "Unfree as the Air," *The Economist,* May 28, 1960.

[5] P. Lyth and H. Dienel, "Introduction," in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), p. 7.

[6] N. Donohue and P. Ghemawat, "The U.S. Airline Industry, 1978-1988 (A), HBS Case 390-025.

[7] A.P. Dobson, *Flying in the Face of Competition* (Hants: Avebury Aviation, 1995), p. 192.

[8] This section draws especially on P. Lyth, "Chosen Instruments: The Evolution of British Airways" in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), pp. 50-86.

[9] P. Lyth, "Chosen Instruments: The Evolution of British Airways" in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), p. 65.

[10] P. Lyth, "Chosen Instruments: The Evolution of British Airways" in H. Dienel and P. Lyth, eds., *Flying the Flag: European Commercial Air Transport Since 1945* (London: Macmillan, 1998), pp. 72-73.

[11] The following description of British Airways in 1986 draws on the company's February 11, 1987, prospectus.

[12] This section draws especially on M. O'Riain, Aer Lingus, 1936-1986: A Business Monograph, 1987 and B. Share, The Flight of the Iolar: The Aer Lingus Experience, 1936-1986 (Dublin: Gill and Macmillan, 1986).

[13] H. Carnegy, "Turbulent Times for Aer Lingus," *Financial Times,* June 3, 1986.

[14] Aer Lingus *Annual Report*, March 31, 1986.

[15] Extract from M.J. Dargan's address to the 50th Anniversary Banquet of Aer Lingus in the Royal Hospital, Kilmainham, 27 May 1986. Quoted in M. O'Riain, *Aer Lingus, 1936-1986: A Business Monograph,* 1987.

[16] H. Carnegy, "Turbulent Times for Aer Lingus," *Financial Times,* June 3, 1986.

[17] Aer Lingus *Annual Report*, March 31, 1986.

[18] This section draws especially on interviews conducted with Ryanair personnel between February 10 and February 17, 2000, including Michael O'Leary, CEO; Declan Ryan, founder; Charlie Clifton, Director of Ground Operations and Inflight; and Kevin Osborne, Director of Purchasing and Administration.

[19] B. Share, The Flight of the Iolar: The Aer Lingus Experience, 1936-1986 (Dublin: Gill and Macmillan, 1986), pp. 203-206.

[20] Aer Lingus *Annual Report*, March 31, 1986.

[21] J. Fagan, "Air Price War Hits Sea Route Traffic," *Financial Times,* September 24, 1987. H. Carnegy, "UK-Irish Air Route Challenge," *Financial Times,* April 24, 1986.