Deregulation and Schedule Competition in Simple Airline Networks

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1. Introduction

In deregulated airline markets, carriers are free to choose the values of the variables affecting their profits. Out of the large number of decisions to be made in practice, the decisions on flight frequency and price on each route in an airlines network are of major importance. Frequency, or the number of flights offered per unit of time, determines consumer welfare by affecting not only the gap between desired departure times and actual departure times, but also the transfer time of passengers who are not on direct flights. Also, total flight frequency has a negative external effect on households suffering from noise and emission of pollutants. Interpreting frequency as quality of service, the frequency decision affects both the number of passengers and their willingness to pay. On the other hand, frequency clearly is a major determinant of airline costs, so that quality is costly to provide. Furthermore, frequency affects both quality of service and - given aircraft size - capacity at the same time and can thus be assumed to influence prices. A further basic aspect of airline markets is the small number of competitors, implying that competing carriers take the possible reactions of their opponents into account when making decisions, e.g., on frequencies and prices. Finally, it has been observed that prices in the airline industry are adjusted daily, whereas changes in frequency (schedules) can be assumed to be much less flexible.

The present paper wishes to model airline competition while taking into account the above observations. Consumer demand is affected by price, schedule delay and transfer time, while the latter two are determined by the airlines' frequency decisions. We consider airline behaviour in a small airline network, under monopoly and duopoly competition respectively and we restrict the analysis to situations where at least one of the firms in the market operates a hub-and-spoke (HS) system. The difference in decision flexibility between frequency and price is accounted for by modeling airline competition as a two stage game: in the first stage, airlines choose schedules, i.e. flight frequencies for each link in their network, while in the second stage, having observed the respective first stage choices, they choose prices. The equilibrium is thus computed as the subgame perfect Nash solution in schedules. A central policy issue addressed by the model is the welfare effect induced by airline deregulation, defined as the introduction of competition in (a part of) the network.

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A number of articles in the large literature on airline (network) competition and deregulation are particularly relevant for this paper. The model has the same two stage structure as the network design model in Lederer (1993), but differs in two ways. Firstly, customer demand is distributed with respect to preferred departure times, so that there is not one least price 'path' per origin-destination (OD) market and more than one firm provide transport between OD markets in equilibrium. Secondly, demand in each market is elastic with respect to both frequency and price. Brueckner and Spiller (1991) use a model of quantity setting duopoly competition in a network; they conclude that with returns to density or cost complementarities in a network, competition in a part of the network may result in an overall welfare decrease because of the negative externalities imposed on the other passengers in the system. Using a similar model Nero (1996) concludes that airline deregulation unambiguously improves welfare in the network when returns to density are absent. The present paper analyzes the introduction of competition in a simple network using the two-stage schedule competition model outlined above.

The paper is organized as follows. We introduce and calibrate the model in the next section, and discuss some of its properties. We then consider simulated market outcomes under monopoly and duopoly competition for two simple airline networks. Section 3 discusses monopoly and leg competition in a one-hub network. In section 4, monopoly and duopoly solutions in a network with two hubs are analyzed. The outcomes under monopoly and competition are compared in terms of welfare.

2. The model

2.1. Demand

A base assumption of the model is that at least one airline operates a hub-and-spoke (HS) system. Therefore, passengers fly either directly to their destination (local passengers) or have to transfer to a connecting flight (connecting passengers). Connecting passengers are assumed to use the services of one airline only during their trip. Furthermore, we do not consider demand for which more than

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2Furthermore, passengers are assumed not to 'bundle' flights, i.e., not to switch between airlines when making a transfer. Lederer (1993) shows that such bundling may lead to non-existence of the price equilibrium.
one transfer is necessary, so that connecting passengers are on two °ights during their trip, passing through two spokes or legs s via a hub. Passengers make one-way trips between nodes (cities) in the network, so that the market m for transport between cities Y and Z represents two one-way markets mY ¡ Z and mZ ¡ Y.

A traveler derives gross utility v from making a trip, and faces a price p. Furthermore, a consumer sufers a linear schedule delay cost µ1x when the °ight leaves at a time distance x = jtdep ¡ tpref j from his or her preferred departure time,3 and a linear travel time cost µ2d, where d is the duration of the trip. Given the network layout, trip duration in the model is x ed for local passengers, whereas it depends on the departure frequency on the second spoke travelled during the trip for connecting passengers. When the gross valuation exceeds the sum of price, schedule delay cost and travel time cost, the traveler buys a ticket. We note that the schedule delay of a connecting passenger is determined by the departure time of the °rst of his two °ights, whereas his travel time is partly determined by the departure time of the second °ight.

Consumer preferences with respect to departure time are represented by a circle of (time) length L on which potential passengers are distributed uniformly. The departure times of °ights on a particular leg of the network are also located on this time circle: we consider the departure times of °ights i and i + 1, t+i and t+i+1 respectively, which are separated by headway H. Flights are spaced equally on the circle. Therefore, the headway is determined endogenously as the time length of the circle divided by the total number of °ights F offered by airlines on the particular leg, i.e.

\[
H = \frac{L}{F} \quad (2.1)
\]

Potential passengers who are 'located' at some preferred departure time x 2 (0; H ) face a time distance x with respect to the departure time t+i of °ight i and a distance (H ¡ x) with respect to t+i+1. These potential passengers derive the following net utilities or consumer surplus from the two options:

\[
\begin{align*}
V_i &= v - p_i - \mu_1 x_i - \mu_2 d \\
V_{i+1} &= v - p_{i+1} - \mu(\mu_1 x_i + \mu_2 d)
\end{align*}
\]

3We thus make the assumption that the utility loss caused by taking a °ight at a time distance x earlier than the preferred departure time is equal to the utility loss caused by taking a °ight at x later than the preferred departure time. The term 'schedule delay cost' is meant to capture both types of utility loss.
Clearly, a consumer will choose the flight belonging to the larger of the above expressions and buy a ticket if the net utility is positive. For the moment, we shall assume that the travel time of the two options is equal. We can now derive the distance $x_{b+}$ between $t_i$ and the boundary between the market areas of the two flights as that value of $x$ for which $v_i = v_{i+1}$. This gives

$$x_{b+} = \frac{p_{i+1} i \ p_i + \mu H}{2\mu}$$  \hspace{1cm} (2.3)$$

All potential passengers located between $t_i$ and $x_{b+}$ will take flight $i$, if they fly at all, and those located between $x_{b+}$ and $t_{i+1}$ will choose flight $i+1$, again, if they fly at all. The number of passengers with preferred departure time $x > 2 (0; x_{b+})$ actually taking flight $i$ is calculated as the number of potential passengers with gross utilities $\mathcal{V} > p_i + \mu x + \mu d$; we represent this number by $D q_i (p_i + \mu x + \mu d)$, where $D$ is a density parameter. Demand for flight $i$ from potential passengers with preferred departure times $x$, $t_i$ can be obtained by adding the number of passengers over all preferred departure times $x$ between $t_i$ and $x_{b+}$. We include the demand from passengers with preferred departure times earlier than $t_i$, giving

$$q = D \int_{x_{b+}}^{x} \mathcal{V} = \int_{x_{b+}}^{x} g \left( p_i + \mu x + \mu d \right) dx$$  \hspace{1cm} (2.4)$$

Aggregate demand for flight $i$ is calculated as the sum of direct passengers and connecting passengers who choose the flight on the first leg of their journey.

We now consider the demand for travel in one-way market $m_{YZ}$, which is either a direct market for local passengers on spoke $s$ or a transfer market for which $s$ is the first spoke to be travelled. Aggregate demand for market $m_{YZ}$ is found by summing $q_{m_{YZ}}$ over all flights. Thus, for an airline $l$ operating a departure frequency $f_{l;s}$ in spoke $s$, demand $Q_{l;m_{YZ}}$ is

$$Q_{l;m_{YZ}} = \sum_{i=1}^{f_{l;s}} q \left( p_i; p_{i+1}; p_i+1; H; d \right)$$  \hspace{1cm} (2.5)$$

The location $x_{bi}$ which marks the boundary between the market areas of flight $i$ and an earlier flight $i-1$ departing at time $t_i$ is found in the same way as $x_{b+}$, i.e.,

$$x_{bi} = \frac{p_{i-1} i i \ p_i + \mu H_i}{2\mu}$$
Finally, total demand for city-pair market YZ is the sum of the demand in the two one-way markets $m_{YZ}$ and $m_{ZY}$ respectively.

2.2. Configurations

We proceed by analyzing the duopoly configuration of flights in a particular time period, represented by the circular 'time' market. For notational convenience, we consider a one-way non-stop duopoly market in the following. Consider a departure $i$ operated by airline $l$. There are three possibilities: departure $i$ may have either two, one or zero neighbouring departures offered by a competing airline $l'$; we refer to such departures as 'unfriendly neighbours', while we call two neighbouring flights operated by one and the same airline 'friendly neighbours'.

The expression for the market boundary $x_b$ in the demand per flight function $q$ depends on the configuration of the departures. With an interlaced configuration, for each departure $i$ the price for both the earlier and the later departure ($i-1$ and $i+1$ respectively) is set non-cooperatively by a competing airline. Note that each airline sets one and the same price for all its tickets, i.e., there is no price differentiation between departures of one rm.$^5$ A departure $i$ with two unfriendly neighbours faces market boundaries

$$x_{b_i} = \frac{p_i \cdot (p_i + \mu H)}{2\mu}$$

$$x_{b+} = \frac{p_{i+1} \cdot (p_{i+1} + \mu H)}{2\mu}$$ (2.6)

from which demand for flight $i$ is derived using equation (2.4). We refer to the demand for this type of flight as $q_{cc}$ or completely competitive demand.

In the case of a non-competitive flight (with no unfriendly neighbours), demand is derived from the market boundaries

$$x_{b_i} = x_{b+} = \frac{H}{2}$$ (2.7)

because prices are the same for these flights. We refer to this type of demand as $q_{nc}$. We note that for any specification of the demand function, completely competitive demand is more price sensitive than non-competitive demand.

$^5$Therefore, in case of a duopoly the price of both competing departures is the same.

$^6$An explicit analysis of demand for the intermediate case of a 'semi-competitive' flight $i$, i.e., a flight with only one unfriendly neighbour $i-1$ and one friendly neighbour $i+1$ is omitted.
For the market as a whole, we can now distinguish between two extremes. In a monopoly market, all departures are offered by the same airline; on the other hand, there is the completely interlaced equilibrium, in which all flights have unfriendly neighbours. Of course, there are many possible configurations between these extremes. The range of configurations implies that with multiproduct competition, monopoly and oligopoly become relative rather than absolute concepts. We consider two configurations in figure 1.

![Diagram of configurations](image)

**Figure 1: Multiproduct configurations**

Note that the number of such flights is always a multiple of 2, and we therefore rewrite the demand for two ‘semi-competitive’ flights as the demand for one competitive flight \( q_{cc} \) and one non-competitive flight \( q_{nc} \).
The first configuration in figure 1 is a completely interlaced duopoly. When a duopolist analyzes the effect of a unit increase in departure frequency starting from a symmetric interlaced configuration, he necessarily considers a 'slightly asymmetric' configuration. As is illustrated in figure 1b, all non-symmetric duopoly configurations are non-interlaced. An implication of the model structure is that the form of the demand functions in an airline duopoly changes at $f_l = f_{-l}$.\footnote{Here and in the following, the subscript $j$ refers to the competitor of airline $i$.} Aggregate demand over all departures $Q$ consists of two parts. For airline $i$, aggregate demand in the market is

\begin{equation}
Q_i = f_l q_{cc} \quad \text{if} \quad f_l \cdot f_{-l} \quad (2.8)
\end{equation}

\begin{equation}
Q_i = (f_l - f_{-l}) q_{nc} + f_l q_{cc} \quad \text{if} \quad f_l > f_{-l} \quad (2.9)
\end{equation}

Using equations (2.1), (2.3), (2.4) and (2.5), we note that

\begin{align*}
\frac{\partial Q_i}{\partial f_l} &> 0 \\
\frac{\partial Q_i}{\partial f_{-l}} &> 0 \\
\frac{\partial Q_i}{\partial p_l} &< 0 \\
\frac{\partial Q_i}{\partial p_{-l}} &> 0
\end{align*}

The demand and profit function of both duopoly airlines have the exact same form. Clearly, when the first line of the demand function is relevant for one airline, the second is relevant for the other. Only when $f_l = f_{-l}$, the two parts of the demand function give the same value.

2.3. Cost and profit

For each flight, the costs consist of a (major) fixed part $F_C$ and a marginal cost $c$ per passenger. The model assumes that each airline $i$ charges a single ticket price for each city-pair market $m$; $m = 1; \ldots; M_i$ it operates. Furthermore, airlines decide on the flight schedule, that is, the departure frequency for each spoke $s$; $s = 1; \ldots; S_i$ in their network. Thus, airline behaviour is represented by the
vectors \( \mathbf{p}_i = f \mathbf{p}_1, \ldots , f \mathbf{p}_M \) and \( \mathbf{f}_i = f \mathbf{f}_1, \ldots , f \mathbf{f}_S \). Using (2.5) and (2.1), profits of airline \( i \) facing a competitor \( j \) in one or more of the markets in its network are

\[
\pi_i = \sum_{m=1}^{M} (p_m - c) \left( f_i, f_j, p_i, \mathbf{f}_j, \mathbf{f}_i \right) \prod_{s=1}^{S} f_{1:s} \mathbf{F} \mathbf{C}
\]

(2.10)

2.4. Calibration

For the calibration of the model we follow the procedure in Norman and Strandenes (1994), viz., solving for the demand parameters using price, frequency, cost and demand observations for a base monopoly situation in combination with the monopolist's first order conditions. Firstly, we impose a linear form on the point demand function \( g(\cdot) \) in (2.4):

\[
g(p + \mu_1 x + \mu_2) = \beta_1 p_i \mu_1 x_i \mu_2
\]

(2.11)

Monopoly demand per flight is then derived as

\[
q = D \int_{x_{\text{min}}}^{x_{\text{max}}} g(\cdot) dx = 2D x_\beta \beta_1 p_i \mu_1 x_i \mu_2 d
\]

(2.12)

Data are available for a non-stop monopoly route only. We note that for such a trip, the monopolists' first order conditions only refer to price and frequency on the leg. With the demand equation, we have a system of three equations, which allows solving for the three demand parameters \( D, \beta_1, \mu_1 \), with \( \beta_1 = \beta_1 \mu_1 \mu_2 \). The data thus do not enable us to directly infer a value for \( \mu_2 \), which represents the common value of travel time. Morrison and Winston (1989) report estimated values of travel and transfer time to be much higher (a factor 10 and 20, respectively) than the value of schedule delay. The relative values seem to depend on the type of traveler. As indicated by Morrison and Winston, business travelers are likely to have a much higher relative value of \( \mu_1 \) than other travelers. Dobson and Lederer (1993), use a value of schedule delay higher than the value

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\( ^8 \) The demand specification ultimately depends on the assumed distribution of gross valuations \( \mathbf{v} \). A well known alternative is the negative exponential distribution, as used in e.g. Evans (1987). However, that specification does not allow one to solve the calibration equations for the parameters of the model. The specification used here is conform Greenhut et al. (1987).

\( ^9 \) Data refer to the pre-deregulation Tel Aviv - Eilat monopoly, and consist of price, frequency and passenger observations. Furthermore, we dispose of passenger and per-flight cost data.
of travel time in their simulation model, while Berechman and de Wit (1996) use a single value of time to calculate utility as a function of flight frequency for local and connecting passengers.\footnote{They do, however, distinguish between business and non-business passengers.} Given the scarcity of evidence and the difficulty of comparing parameter values between rather different models, we do not assign a fixed value to $\mu_2$ here. Rather, we investigate the sensitivity of the results to changes in the relative value, and look for restrictions on the parameter value in the next section.

As indicated above, for local passengers, the utility loss caused by the time involved in the trip is represented by the parameter $b = \mu_1 \mu_2 d$. For connecting passengers, the calculation differs on three accounts. Firstly, the trip consists of two leg flights. Secondly, the connecting passengers have to wait for a connecting flight. Thirdly, the gross trip valuation may differ between non-stop and on-stop travel. In order to simplify the calculations, we have assumed the following. For connecting passengers', gross trip valuation is higher than for local passengers, e.g., because of the larger travel distance. However, the difference in trip valuation is exactly matched by the utility loss derived from the incremental travel time. Therefore, the parameter $b$ has the same value for both passenger types. The difference between the demand functions, however, stems from the waiting time of the connecting passengers, which depends on the frequency of the airline on the second leg of the trip. We thus have, for connecting passengers

$$d_c = \frac{1}{L_{12}} = \frac{1}{F_{12}}$$

(2.13)

where $1$ is a parameter indicating proportion of the headway time on the second leg which the passenger has to wait, with $0 \leq 1 \leq 1$. Thus, even at a low frequency on the second leg, the waiting time can be small when arrival and departure times of connecting flights are close. We have chosen an arbitrary value of $1 = 0.5$ in the calculations. The base set of parameters is presented in Table 1, with all monetary equivalents in US$. 

$\begin{array}{|c|c|c|}
\hline
\text{Parameter} & \text{Value} & \\
\hline
\mu_1 & 10 & \\
\mu_2 & 5 & \\
L & 100 & \\
F & 10 & \\
\hline
\end{array}$
Table 1:

<table>
<thead>
<tr>
<th>base simulation coefficients</th>
<th>calibrated parameters</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>0:49</td>
</tr>
<tr>
<td>$\theta$ ($)</td>
<td>174:47</td>
</tr>
<tr>
<td>$\mu_1$ ($)</td>
<td>131:58</td>
</tr>
<tr>
<td>imposed parameter 1</td>
<td>0:5</td>
</tr>
<tr>
<td>cost parameters ($)</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>5</td>
</tr>
<tr>
<td>FC</td>
<td>1500</td>
</tr>
</tbody>
</table>

Using these parameter values, we simulated frequency and price decisions in network markets. The simulation results are presented and discussed in the next sections.

3. A one-hub network

In this section, we consider the effects of introducing competition in a simple network consisting of one hub and two spokes, as depicted in Figure 2. We assume that the network is symmetric in the sense that legs 1 and 2 have the same length, and that all markets have the same density. Using the same type of aircraft on both legs, the demand and cost characteristics are equal on non-stop flights.

3.1. Monopoly

We first consider the schedule choice of a monopolist, who operates a HS system in the above network. As the monopolist does not have to take into account the
possible actions of an opponent, the problem is simply

$$\max_{\bar{f}; \bar{p}} \prod_{m=1}^{M} (\bar{p}_m \cdot c) Q_m \prod_{i}^{\bar{f}} \bar{p}_i \prod_{s=1}^{S} f_s F C$$

(3.1)

where $M$ is the number of markets, and $S$ the number of spokes. Clearly, the number of spokes is two, so that $\bar{p} = pf_1; f_2 g$. We distinguish three city-pair markets, viz., the local markets $AH$ and $HB$, and the connecting market $AB$, so that $\bar{p} = fp_{AH}; p_{HB}; p_{AB} g$.

We start by considering the price solution of the monopolist. Using (2.12), we derive as the monopoly pricesolution for a given market

$$p_{mon}^{\pi} = \frac{c + \bar{p} \cdot \mu_1 \cdot \mu_2 d}{2}$$

(3.2)

We may conclude that, for given sight frequency, the profit maximizing monopoly price decreases in both $\mu_1$ and $\mu_2$, and so, given (2.12), revenues decrease in both parameters. Similarly, we can derive an expression for the frequency decision of the monopolist. Considering a non-stop market for simplicity, we have

$$F^{\pi}_{mon} = \frac{s \cdot (\bar{p} \cdot c) \mu_1 L}{4 F C}$$

(3.3)

Next, we analyze the simultaneous solution to the monopoly network problem (3.1). Using the parameters from Table 1, we solve for $\bar{f}$ and $\bar{p}$ for varying $\mu_2$, we have calculated profit maximizing frequencies and prices for a range of values of $\mu_2$. The results are presented in Figure 3, which only shows results for one of the two identical local markets and legs.
As Figure 3 illustrates, the price in the connecting market decreases in $\mu_2$, as the travel time costs increase. The monopolist can counteract the negative demand effect by increasing the departure frequency in the legs (which has a small positive effect on the price in the direct market). The profit maximizing frequency is concave in $\mu_2$. Clearly, the overall effect of an increase in $\mu_2$ on profit is negative. From this conclusion, we can derive a restriction on the value of $\mu_2$. From the calibration data, we know the profit of a single-leg market. A monopolist will choose a HS network, whenever the profit of such a network is larger than the profit in a fully-connected (FC) network. Therefore, from the assumption that the monopolist operates a HS network, a maximum value for $\mu_2$ follows, viz., the value of $\mu_2 = \bar{\mu}_2$ for which the profit of both network types are equal. Put differently, values of $\mu_2$ have to be consistent with the choice of the network type. In the following simulations, we use the maximum value of $\mu_2$ consistent with the HS network type, viz., $\mu_2 = 0.8 \times \mu_1$.

3.2. Leg competition

We now consider the introduction of competition in leg 1 of the network in Figure 2, e.g., after entry of a small airline only serving the local market between H and B. An important asymmetry is thus present in the competition in market 1. The
incumbent, airline 1, carries both local and connecting passengers on leg 1, while
the entrant, airline 2, only carries local passengers.

We consider the outcome of the following two-stage frequency and price game. Both airlines face the profit function

\[
\pi_l = \sum_{m=1}^{M_l} (p_m - c_m) Q_m \left( p_i - \frac{f_{il} + f_{il}^2}{2} \right) f_{i,s} F C
\]

with \( M_1 = 3; M_2 = 1 \) and \( S_1 = 2; S_2 = 1 \). The equilibrium is found by solving the game backwards: for each pair of schedules \( f_{il}; f_{il}^2 \) the Nash equilibrium in prices \( p_i; p_i^2 \) is calculated as the set of prices at which

\[
\pi_l^f > \pi_l^f; \pi_l^f; p_i^f; f_{il}^f \quad ; \quad l = 1; 2
\]

(Note that for airline 2, the problem is confined to finding a single departure frequency and a single price). Given the second stage price equilibria, the first stage Nash equilibrium in flight schedules is calculated as the set of schedules for which

\[
f_{il}^f; f_{il}^f; p_i^f; p_i^f \quad > \quad f_{il}^f; f_{il}^f; p_i^f; p_i^f \quad ; \quad l = 1; 2
\]

The first stage equilibrium choices and market outcomes are compared with the monopoly solution in Table 2 below.

<table>
<thead>
<tr>
<th>Monopoly</th>
<th>Leg competition</th>
</tr>
</thead>
<tbody>
<tr>
<td>airline 1</td>
<td>airline 2</td>
</tr>
<tr>
<td>schedules</td>
<td>f29; 29g</td>
</tr>
<tr>
<td>prices</td>
<td>f76; 76; 54g</td>
</tr>
<tr>
<td>passengers</td>
<td>f1673; 1673; 1161g</td>
</tr>
<tr>
<td>pro’t</td>
<td>121221</td>
</tr>
<tr>
<td>CS (’000) per market</td>
<td>f62:4; 62:4; 31:5g</td>
</tr>
<tr>
<td>CS total</td>
<td>156326</td>
</tr>
<tr>
<td>welfare</td>
<td>277547</td>
</tr>
</tbody>
</table>

We note a few interesting characteristics of the equilibrium. As explained in section 2, asymmetric frequency choices result in non-interlaced configurations.
of departures. This confers the monopoly power to the airline with the higher number of departures, which explains the asymmetry in pricing. Clearly, the schedule asymmetry is determined by the network asymmetry: for airline 1, the marginal flight has a higher profitability because it serves both the local duopoly market and the monopoly market for connecting passengers.

The overall conclusion is that leg competition raises welfare. Not surprisingly, a reallocation of surplus from producers to consumers takes place. Aggregate consumer surplus increases by some 23%, which represents a gain for local travelers in market 1 (60%), a loss for connecting passengers (-6%), while nothing changes for local passengers in market 2. Note that the welfare loss for connecting passengers caused by airline 1's frequency decrease in leg 1 is partly compensated by the lower ticket price. This conclusion is partly in line with the conclusion by Brueckner and Spiller (1991). In their model, leg competition raises welfare for local passengers in market 1 and hurts connecting passengers too. The reason for the latter welfare effect is, however, the existence of negative cost externalities between markets, which also causes a welfare reduction for local passengers in market 2. In our model, connecting passengers are affected through the higher costs of schedule delay and travel time, not through an increase in price (marginal cost). Therefore, local passengers in market 2 are not affected, while local passengers in market 1 benefit from both higher flight frequencies and lower prices.

Note that the two-stage character of the model gives both airlines an incentive not to choose symmetric frequencies: with a symmetric, interlaced configuration of departures, price competition is more intense and second stage prices are lower than in a non-symmetric equilibrium. Finally, we note that the model outcomes represent a slight S-curve effect, that is, airline 1, carries a share of the passengers traveling on leg 1 that is higher than it's share of departures. The effect is a result of the connecting travel carried by airline 1 while having a lower than proportional share of the local traffic, as a result of the high price in market 1.

4. A two-hub network

In this section, we investigate the solution of firms to the network frequency-price problem for a slightly more complex network under regimes of monopoly and competition. The network under consideration now consists of 2 hubs and three spokes or legs, as depicted in Figure 4.
4.1. Monopoly

The monopoly network problem has the same general form as for the one-hub network presented in (3.1). In this case, however, \( S = 3 \) and we distinguish \( M = 5 \) city pair markets, viz., three markets for local passengers \( A H_1, H_1 H_2, H_2 B \) and two markets for connecting passengers \( A H_2 \) and \( H_1 B \).\(^{11}\) The monopoly network problem can be interpreted either as the scheduling problem of a single airline operating two hubs or as the problem of two airlines maximizing joint profits. In the latter interpretation, local market \( H_1 H_2 \) may represent a route market between hubs of \(^{o}ag\) carriers before deregulation in the European Union, which until recently were governed by restrictive bilaterals, while the other markets can be thought of as hinterland monopoly markets in the absence of cabotage, e.g., as in Nero (1996).

Using the same parameters as in the one-hub system, the (base) solution to the monopoly scheduling problem is \( \Gamma = f f_1; f_2; f_3 g = f 36; 29; 29 g \) and \( \pi = f p_{H_1 H_2}; p_{H_2 B}; p_{A H_1}; p_{A H_2}; p_{H_1 B} g = f 79; 76; 76; 58; 58 g \). As before, \( \mu_2 = 0.8 \pi \mu_1 \), a value at which the HS system is slightly more profitable than the FC system. As before, equilibrium profit decreases in \( \mu_2 \).

4.2. Hub competition

We now consider the case of competition on the local market \( H_1 H_2 \). The situation can be interpreted as an example of partial deregulation, in the sense that a collusive bilateral, containing capacity and fare restrictions is abolished for the international route \( H_1 H_2 \), while carriers continue to operate monopoly routes

\(^{11}\)As indicated before, we do not consider trips for which more than one transfer is necessary.
within their respective countries. The model assumes that two identical airlines with identical hinterland markets compete on $H_1H_2$. In the following, airline 1 operates the monopoly markets $AH_1$ and $AH_2$, and airline 2 operates monopoly markets $H_1B$ and $H_2B$.

The results of the base simulation are compared with the monopoly regime in Table 3.

<table>
<thead>
<tr>
<th>Marketequilibria: 2 hub network</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monopoly</td>
</tr>
<tr>
<td>airline 1</td>
</tr>
<tr>
<td>schedule</td>
</tr>
<tr>
<td>prices</td>
</tr>
<tr>
<td>passengers</td>
</tr>
</tbody>
</table>

A basic characteristic of the equilibrium is the asymmetric frequency choice on leg 1. This result is due to the second stage price competition: airlines have an incentive to avoid symmetry, as this results in lower equilibrium prices. In equilibrium, airline 1 operates 3 monopoly flights, which enables it to charge a higher price in the duopoly market $H_1H_2$. The higher frequency of airline 1 in leg 1 also lowers schedule delay and travel time for its transfer passengers relative to those of airline 2, so that the price in market $AH_2$ is higher than in airline 2's transfer market $H_1B$.

A comparison of the monopoly and hub competition regime shows that the individual duopoly airlines have a lower flight frequency on each leg than the monopolist. On legs 2 and 3, the difference is quite small. On leg 1, however, the individual flight frequencies are much lower with competition, while the combined flight frequency on this leg is much higher. As we have assumed that connecting passengers never transfer to a flight operated by another airline, the connecting passengers suffer from higher travel times as a result from the decrease in airline flight frequency. This decrease in utility is reflected by the lower transfer demand

12 Although the model is different, the results are close the those obtained in two-stage quality-price competition (Shaked and Sutton, 1982), where firms differentiate in order to avoid price competition. In fact, there are two pure strategy asymmetric equilibria with identical firms, only one of which is presented. Furthermore, we do not consider mixed strategies here.
and the much lower prices in the transfer markets of both airlines. The local passengers in duopoly market $H_1H_2$ do benefit, both from increased flight frequency and lower prices because of price competition. In this market, there is a significant increase in passengers.

In Table 4 below, welfare results of both regimes are compared, where the welfare total is defined as the sum of consumer surplus in all markets plus industry profit. A first result of deregulation in market $H_1H_2$ is a dramatic decrease in industry profit. Secondly, there is an increase in total consumer surplus. The table shows that the aggregate increase is the sum of a gain for local passengers (in market $H_1H_2$) and losses for connecting passengers. The result of these opposing changes is a net decrease in the welfare sum.

<table>
<thead>
<tr>
<th></th>
<th>Monopoly</th>
<th>Hub competition</th>
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</thead>
<tbody>
<tr>
<td>industry profit</td>
<td>215016</td>
<td>138545</td>
</tr>
<tr>
<td>CS ('000) per market</td>
<td>f66; 62; 62; 40; 40g</td>
<td>f127; 62; 62; 28; 31g</td>
</tr>
<tr>
<td>CS total</td>
<td>269875</td>
<td>309454</td>
</tr>
<tr>
<td>welfare</td>
<td>484891</td>
<td>447999</td>
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</table>

The general welfare result above is qualitatively in line with earlier work on the effect of deregulation in network markets. Nero (1996), using a similar HS network, concludes that for particular parameter combinations in his model, welfare (the sum of consumer surplus and profits) over all markets in the network is higher under monopoly (after an airline merger) than under competition. Brueckner and Spiller (1991) reach a similar conclusion for leg competition. In these papers, the form of the cost function drives the results. In particular, the cost function reflects increasing returns to traffic density, that is, marginal passenger costs are decreasing.

In our model, marginal passenger costs are constant, so that network externalities take the form of demand rather than cost complementarities. This difference, which follows from the model specification, has a number of implications. As indicated in the previous section (leg competition), the introduction of competition in a number of simulations, the sensitivity of the welfare results with respect to the value of travel time parameter $\mu$ has been investigated for parameters in the range $0.2\mu_k \cdot \mu_k \cdot \mu_h$. As is to be expected, the negative welfare effect of deregulation increases in $\mu_k$; the qualitative conclusions remain, however, unchanged.
a local market does not result in higher marginal costs and prices for connecting passengers in our model. Rather, prices decrease for connecting passengers, as their net trip utility decreases in travel time. However, consumer surplus for connecting passengers still decreases, as the price decrease does not compensate the travel time increase. Similarly, the marginal passenger cost of local passengers, e.g. in market \( AH_1 \), is constant, so that demand, price and consumer surplus changes, if any, are due to changes in the \( \delta \)ight frequency on leg 2. The consumer surplus change is still positive, but is smaller than the \( \pi \)t decrease, so that the overall welfare \( \pi \)ect is negative in the two hub model.

Finally, we note that external costs have not been taken into account in the analysis. However, one can expect increased environmental costs in the network, e.g. taking the form of noise and emissions, after deregulation. The \( \pi \)ects are not evenly spread over the network. Whereas there is a slight decrease in aircraft movements at airports A and B, there a signi\( \pi \)ant net increase at the hub airports. Clearly, including the external cost to the analysis would only add to the negative welfare result for the hub competition model.

5. Conclusion

This paper presents a model of schedule competition in simple airline networks. We model airline competition in frequencies and prices as a two stage game: in the \( \pi \)rst stage, airlines choose frequencies on the legs in their network, in the second stage they choose prices for direct and connecting markets. The two-stage setup of the model allows airlines to choose asymmetric frequency equilibria such that price competition is avoided. We consider \( \pi \)t maximizing schedule solutions for two types of networks, and compare monopoly solutions with competition in part of the network.

The numerical results indicate that for both types of networks, the introduction of competition, deregulation, in part of the network has a positive \( \pi \)ect on aggregate consumer welfare. However, consumers in transfer markets lose because, under the assumption that they do not transfer to a competing airline's \( \delta \)ight, their schedule delay and travel time costs increase. Furthermore, industry \( \pi \)t decreases after deregulation.

In the case of leg competition in a one hub model, the positive consumer surplus \( \pi \)ect dominates the \( \pi \)t loss, resulting in an increase in overall consumer surplus. In the case of hub competition, the \( \pi \)t loss dominates, so that there
is a net welfare decrease.

6. References


