Come Rain Or Shine

Rising fuel prices and global economic worries are challenging the low-cost carrier business model differently, depending on the region.

By Lynne Clark | *Ascend* Staff

Global forecasts for low-cost carriers this year are as varied as the climates in which they operate. Overall, the sector grew 20.1 percent last year versus 2006, with 4.6 million scheduled flights, according to the OAG, a global flight information company. The group reported that low-cost operations during 2007 represented 16 percent of all flights worldwide and 19 percent of all seats globally, up from 14 percent and 17 percent, respectively, the previous year. But rising fuel prices and fallout from the global credit crunch will cloud profit predictions in many regions based on each market's unique economic climate.

United States — Mostly Cloudy

"Mostly cloudy" is the forecast for U.S. LCCs, which are feeling pressured by a slowing economy and over-capacity concerns. The two largest carriers, Southwest Airlines and jetBlue Airways, both cut 2008 capacity growth plans. Last December, Southwest trimmed growth plans to approximately 5 percent — about half of its previously announced plan. In January, jetBlue followed suit by downsizing its capacity growth plans from 13 percent to between 6 percent and 9 percent. The New York-based carrier has also sold two Airbus A320 aircraft during the first half of the year, and it will sell an additional four of the same aircraft by the end of the year.

Dwindling domestic opportunities for U.S. LCCs are forcing them to rethink traditional business models. Most are realizing they can't survive without the business customer. The new model strays from the segment's no-frill roots and introduces opportunities for LCCs to craft corporate travel deals; participate in global distribution systems; and offer paying perks such as lounges, leather seats, extra leg room, speedy boarding and frequent-flyer miles.

Photo courtesy of Airbus

U.S.-based low-cost carrier jetBlue Airways has cut capacity growth plans, sold two of its Airbus A320 aircraft and will sell four more by the end of the year as a result of a slowing economy and over-capacity issues.

That's the strategy behind Southwest's introduction late last year of a new fare category designed for business travelers. The carrier has tripled its corporate sales force and started listing fares and inventory on GDSs.

JetBlue is offering refundable fares for an extra US$50 to US$100 after testing the concept with corporate accounts and has hinted at "an enhanced front-cabin product" now in development. Orlando, Florida-based AirTran Airways, which has come the farthest among U.S. LCCs in negotiating volume discounts, introduced optional advance seat assignments, allowing passengers to pay more for sitting in a roomier row, for example.

"You'll see a lot more product differentiation as low-cost carriers scramble to compete with each other and with network carriers," said Garth Overmyer, principal of global airline distribution for *Sabre Airline Solutions*®. "So instead of no frills, they'll feature menus of frills customers can pay for, essentially becoming hybrid carriers."

Contributing to the hybrid image is an increased focus on international markets made possible by liberalization of international flying rights through the recent open-skies agreements.

"There has been a lot of talk and speculation these days, especially about Southwest, that it will either purchase or partner with some other low-cost carrier to go international," Overmyer said. "Southwest has publically stated that it would be willing to purchase another airline, even if it doesn't fly all Boeing 737s. That's a pretty bold statement.

"In addition, jetBlue and Aer Lingus have announced a new partnership, and Lufthansa has a 19 percent stake in jetBlue.

Photo courtesy of Boeing

AirTran Airways continues to add "frills" to its low-cost model, such as optional advance assigned seating that gives passengers the ability to select a row with more space for an extra fee, to help differentiate itself from its LCC and network competitors.

Spirit has aggressive expansion plans that include 40 percent growth, 20 more frequencies and 10 new routes, mostly to the Caribbean and Latin America. It's a whole new frontier."

Europe — Cloudy With Potential Storms

European low-cost carriers fared much better in the last quarter of 2007 than did their U.S. counterparts. Overmyer attributes the difference to ancillary revenues and capacity differences.

"Ancillary revenue, including baggage charges and commission earnings from areas such as hotel bookings, car hire and travel insurance, drives revenue performance for European LCCs," he said. "It's second nature to them to charge for things U.S. passengers are used to getting for free.

"Additionally, the United States has more capacity than Europe, which has driven demand and sustained profits in the past. But the honeymoon is about over. Within the next two years, Europe's carriers will begin to deal with the same capacity issues that are hindering U.S. carriers."

Ryanair, Europe's leading low-cost airline, warned in February profits could fall as much as 50 percent in its next financial year due to a "perfect storm" of rising oil prices, tougher economic conditions and falling fare levels.

In stark contrast, easyJet, the United Kingdom's leading LCC, has maintained its forecast for a 20 percent increase in underlying pre-tax profits in its financial year that ends in September. Total revenues per seat rose ahead of expectation by .05 percent in the airline's first quarter that runs October to December. Revenues were boosted by a strong euro and the introduction of baggage charges, in addition to expanding markets in continental Europe, particularly Italy, Spain and Switzerland.

Asia/Pacific — Sunny

The forecast is sunny for Asia/Pacific LCCs. By 2012, LCCs as a group plan to expand capacity by 250 percent and triple their combined fleet to 200 aircraft by 2012, the Centre for Asia Pacific Aviation noted. The group expects an "unprecedented period of international route development in the region."

The forecast is based on announced aircraft orders by existing LCCs, reported in CAPA's Outlook 2007. Given reasonably sound fundamentals over the rest of this decade, the number of new entrant LCCs will grow significantly, the report said.

Outlook 2007 also stated that Asian airlines have planned deliveries during the next five years that represent almost 59 percent of the current fleet — well ahead of the global average of 31 percent despite the fact that, in most cases, Asian airlines possess younger fleets than the global average.

"The expected surge in deliveries is potentially a concern, with overall profitability falling despite a generally benign business environment in 2006," said Peter Harbison, executive chairman of the Centre for Asia Pacific Aviation. "But the Asian markets are by no means mature at this stage and, while the level of deliveries may suggest youthful exuberance, disproportionate growth is quite possible."

There are structural reasons why this region should have a higher proportion of new aircraft orders than elsewhere, notably the rapid liberalization of markets that have been tightly held for decades, along with the correspondingly higher opportunities for short-haul, intra-Asian services, which flow directly from local deregulation and increased bilateral trade. Aircraft deliveries during the next five years will also be focused on the fastest-growing markets — in particular, China and India — where there is great potential for demand growth to absorb new capacity additions, according to the report.

These factors, combined with strong underlying rates of economic growth and rising personal incomes, should ensure a bright future for LCCs in Asia/Pacific.

"It will be interesting to see how things develop in the Asian and Indian markets," said Overmyer. "Because markets are emerging, these carriers have the advantage of new technology and the ability to sell ancillary services right off the bat and not have to change their whole infrastructure to achieve new hybrid strategies.

"The region is not without its challenges, however. Asian customers are slow to adopt Internet technologies to buy tickets, so most are sold through travel agencies. Internet adoption and infrastructure are big challenges for these emerging markets, but the potential is huge."

Photo courtesy of Airbus

Leading the low-cost carrier position in the United Kingdom, easyJet expects underlying pre-tax profits to rise 20 percent in its financial year ending in September. Expanding markets, the implementation of baggage charges and a strong euro have contributed to the carrier's continued success.

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