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ON THE ROUTE TO RECOVERY

A conversation with ...

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President
and CEO,
Gulf Air**

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Recent Breakthroughs
in Revenue Management

Leveling the Playing Field

Revamping their business models enable network carriers to remain competitive and return to profitability despite the growing low-cost segment.

■ By Emre Serpen | *Ascend* Contributor

It was a tiny upstart that changed the world. Challenging the industry leaders by offering low prices and good customer service, the startup gradually grabbed market share until it became one of the most powerful companies in the world.

And what Wal-Mart did to retailing in the '80s is being echoed in the airline industry today.

Companies such as Southwest Airlines, Ryanair, easyJet, jetBlue, Virgin Blue and numerous others have carved an increasingly larger niche for themselves by — like Wal-Mart — offering low prices and good customer service.

These companies have enjoyed the benefits of a lower cost structure, in many cases because they didn't inherit costly labor contracts developed under a regulated environment

where profits were virtually guaranteed or the complex procedures and overhead from being a government-owned flag carrier. In many cases, the low-cost carriers have also chosen to serve secondary cities and airports where it costs less to operate. With their much lower costs and presence in lower served markets, they are growing rapidly.

Because they offer such low fares, they have made air travel feasible for a larger number of people, thereby helping stimulate traffic. Many of these carriers also have focused on underserved markets, providing direct service to new destinations.

As these carriers continue to increase their reach — in the United States, nearly 80 percent of markets are subject to low-cost competition — the traditional network carriers are being forced to respond.

low-cost threat because they lack the size, market reach and production efficiencies of major network carriers and the cost and utilization advantages of low-cost carriers. Some of these carriers have rein-

vented themselves as low-fare airlines with spectacular success.

Two years ago, Aer Lingus, the Irish flag carrier, was on the verge of bankruptcy as it battled with low-cost Ryanair. Under the leadership of Chief Executive Officer Willie Walsh, the airline has transformed itself into a successful and profitable low-fare carrier. Although its yields have dropped by 23 percent, its per-kilometer costs dropped even more significantly by 35 percent resulting in a 6.6 percent boost in profits to €64 million (US\$82 million) in 2002. The airline

aggressively cut overall costs by 30 percent, reducing labor costs by 33 percent and distribution costs by 51 percent. The lower cost structure enabled Aer Lingus to remove price restrictions on trans-Atlantic flights and reduce business fares by up to 60 percent. The successful transformation enabled Aer Lingus to start 28 new routes in two years.

In March 2002, America West Airlines introduced a new pricing structure throughout its network that significantly reduced one-way and unrestricted walk-up fares and eliminated the traditional Saturday night stay requirement. The new structure cut America West's

Dallas Love To Little Rock

Select Departure Date...

November 1

November 2003						
Sun	Mon	Tue	Wed	Thu	Fri	Sat
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
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30						

Available Fares		
Display	Fare	Price
<input checked="" type="checkbox"/>	Saturday Advance (Y)	\$91
<input checked="" type="checkbox"/>	Internet One-way (V)	\$39.44

Click on Update Calendar to display selected fare availability.

Update Calendar

Transparency of pricing and restrictions due to the availability of fare information over the Internet has fueled a growing trend of reducing complex pricing rules and simplifying fare structures. Such transparencies have also led passengers to expect consistent and simple pricing rules. For example, Southwest Airlines, which pioneered the low-cost carrier model, makes price, rule and availability 100 percent transparent to its passengers, who book flights on its Web site, leading other airlines to increase transparency as well.

Fortunately for network carriers, there are ways they can compete with the growing low-cost carrier segment and continue recovering in improved economic times. Depending on a carrier's circumstances, there are three primary ways it can respond:

- Transform to a low-cost carrier,
- Leverage network advantage,
- Start a low-cost carrier within a carrier.

Becoming a Low-Cost Carrier

Smaller carriers with high costs and without the revenue advantage of major network carriers are particularly susceptible to the



unrestricted fares by 40 percent to 70 percent below those of other major carriers, according to the airline.

America West, now the second-largest low-fare carrier in the United States, has improved its financial performance as a result of the transformation. In the nine full months following implementation of the new fare structure, the airline reported one of the largest domestic revenue per available seat mile increases among major airlines.

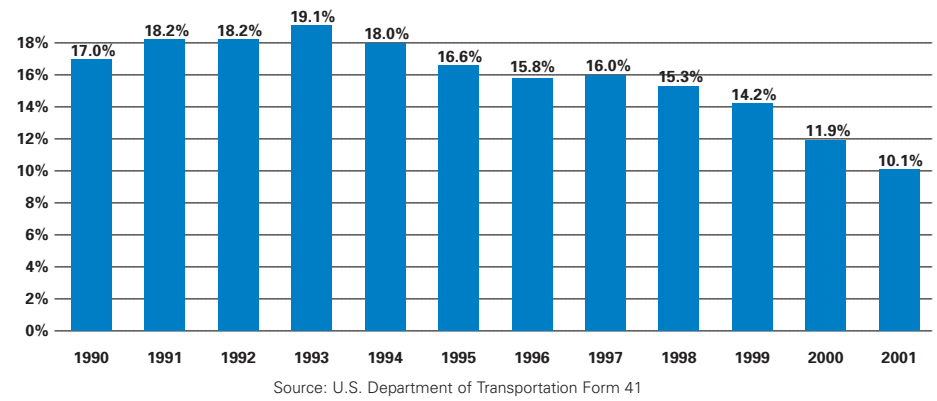
"America West, like other low-fare carriers, continues to experience impressive year-over-year gains in market share," said Scott Kirby, executive vice president, sales and marketing at America West announcing the 2002 results. "Our 26 percent increase in traffic is well in excess of the industry average and is driven by tremendous consumer response to our business-friendly fare structure."

In 2003, America West was one of the first airlines to return to profitability in the second and third quarters, and it reported a net income of US\$57.4 million for the year. Operating costs for the year per available seat mile declined 2.5 percent despite an 8.5 percent increase in the average fuel price. And, for 2003, the company reported total cash and investments of US\$629.5 million, the highest cash balance in the company's history.

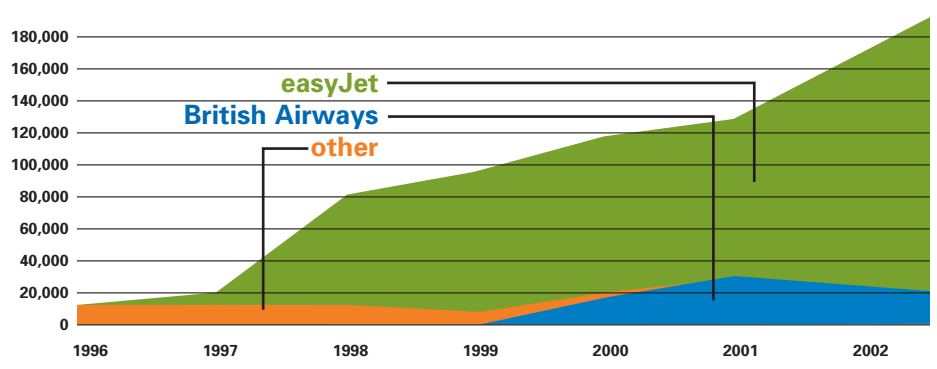
Exploit Network Advantage

Most traditional network and flag carriers have an advantage over their low-cost counterparts because of their extensive network that serves a number of domestic and international destinations. By lowering costs in their domestic product, they can feed more passengers into their more profitable, long-haul operations.

U.S. Major Air Carriers Have Successfully Reduced Product Distribution Costs



Liverpool/Manchester-Nice Schedule Passenger Traffic



Top: Direct distribution offers a way for airlines to dramatically reduce distribution costs. In the United States, major carriers have increasingly used their own Web sites as a way to significantly reduce distribution costs. In 2001, distribution costs shrank to just over 10 percent, down from more than 19 percent in 1993.

Bottom: As easyJet showed on its Liverpool/Manchester to Nice routes, serving an underserved market with low costs proves beneficial. The carrier experienced eightfold growth on the route compared to incumbent carriers. Such a business model has led to the growth and profitability of low-cost carriers around the world.

THE HIGH LEVEL view

News Briefs from Around the Globe

Who

Sabre Airline Solutions

What



Released new enhancements for its reservations and departure control systems.

Why

To increase usability and help improve agent productivity. The enhancements include a major revamp of the graphical user interface to *SabreSonic™* Res and *SabreSonic™* Check-In. The company also introduced an upgrade to

the *Control Center* that manages these systems, strengthening their codeshare capabilities. The new GUI uses open-systems and Internet technology to simplify the reservations and check-in process, improve airline agent productivity and enhance customer focus. [E](#)

Transforming the Business Model

Key areas to transform	Current Model	New Model
Destinations	Highly dispersed	Focused
Frequency (scheduled)		
Fleet	Highly mixed types	Consolidate fleet to the extent possible
Hub vs point to point	No hub structure/very poor flows	Leverage selected flows, and point to point
Charter vs Scheduled ops	Undefined mix	Differentiate scheduled and charter on frequency
Market segments	Low yield	Medium and low yield

Plan

- Reduce costs €190 million
- 17% reduction in ASK
- 2000 staff reduction 33%
- Remove price restrictions, load factor in trans-Atlantic flights >80%
- 60% reduction business fare
- 28 new routes in two years
- Direct distribution

Results ('01-'03)

- ASKs (6%)
- RPKs (7%)
- Load factor (11 points)
- Average yield (-23%)
- Cost per RPK (35%)
- Profit (6.6%) €64 million

Above: Traditional airlines can become more competitive with their growing low-cost counterparts by transforming their business models. Although there is no single magic formula, there are some things traditional airlines can do in the areas of destinations served, schedule frequency, fleet consolidation and market segmentation to reinvent themselves to compete with the new breed of carriers and ensure long-term sustainability.

Right: Facing bankruptcy, Aer Lingus implemented a plan to transform into a low-cost carrier to compete with Ryanair. By reducing costs by 35 percent, the airline earned a €64 million (US\$82 million) profit.

To maintain that domestic feeder network, they need to lower their costs to be competitive on the short-haul routes. There are ways airlines can reduce costs other than by focusing on labor.

The traditional carriers are subject to rigid labor contracts and larger overheads, but their response has been consistent: reduce costs and complexity as much as feasible and

reduce fares on short-haul routes. However, network carriers can also improve their competitiveness within the constraints of existing labor contracts by rationalizing their network, reducing the number of fleet types, improving the production planning processes and reducing distribution costs.

Distribution offers tremendous savings for carriers. Since the mid '90s, U.S.-based

carriers significantly reduced their distribution costs by 10 percent and more in some instances.

By investing in direct channels of distribution such as its Web site and revising its commissions, Delta Air Lines reduced its distribution costs by US\$295 million, or nearly 45 percent of its US\$652 million cost-reduction program. Similarly, Continental Airlines

THE HIGH • LEVEL view

News Briefs from Around the Globe

Who


WestJet

What

Selected the Sabre Airlines Solutions suite of resource management products to help the airline more effectively manage its staffing levels at all its airport locations.

Why

"Our primary goal in choosing a technology partner is to join forces with an industry provider that is knowledgeable, flexible and adaptable and will align its solutions with our business goals," said Dale Tinevez, WestJet director, airports.

"From the very beginning, Sabre Airline Solutions has been concerned not only with our current needs, but how these resource management technologies will fit with our future expansion." 



reduced its distribution costs by US\$217 million, or one-third of its total cost-reduction program. British Airways is pursuing an aggressive cost-reduction program seeking to simplify its operation and reduce its fares significantly, particularly on short-haul European routes. And Aer Lingus revamped its fleet moving to a single-type, the Airbus A320, and revised its route structure, adding 30 new routes.

Airlines that are working toward transformation should focus on taking the full advantage of both cost and reach opportunities offered by direct distribution. In the United Kingdom, FlyBE, the nation's third largest low-cost carrier, increased its direct distribution from 5 percent to 80 percent within one year by changing its distribution strategy to focus on direct distribution, including much greater use of its Web site.

Carrier Within a Carrier

When bmi surveyed a competitive landscape with rising challengers such as Ryanair and easyJet, it realized it needed to take a radical step to compete. Its response was to form bmibaby, its low-fare subsidiary that took over the airline's entire operations at its Nottingham East Midlands Airport home base. The low-cost subsidiary has helped its parent airline fend off the low-fare competition. Last year, bmibaby helped the parent group carry a record 9.4 million passengers. Other carriers — Delta with Song, United with Ted, Air Canada with Zip, Singapore with Tiger Airways and Qantas with Jetstar — have developed low-fare subsidiaries to maintain market share in the new price-driven environment.

The low-cost subsidiary should not be a standalone response. Throughout their operations, airlines must also aggressively reduce operating costs, pursue production efficiencies and seek to lower unit costs, which would enable them to reduce their fares. Although many industry analysts are skeptical about the prospects of low-cost subsidiaries, they may work provided they can achieve true cost advantages and not infringe on the parent airline's network.

Whether transforming to a low-fare airline, exploiting the advantage of an extensive network or forming a low-fare subsidiary, airlines are pursuing aggressive transformation programs and reinventing their business model.

Business Transformation

As low-cost carriers continue to grow rapidly worldwide, they will increasingly put

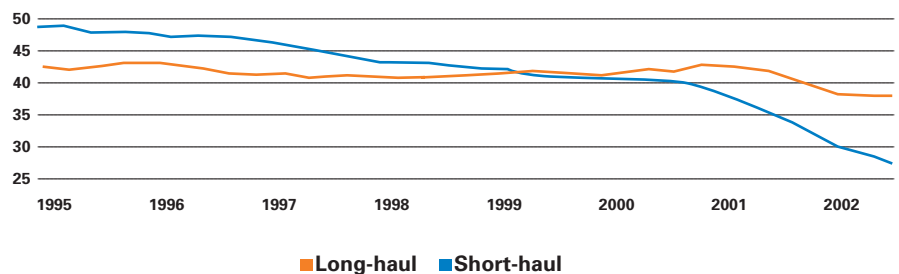
pressure on network carriers' fares and market share.

The root cause of the traditional carriers' disadvantage is not revenue but costs. The average revenue per available seat kilometer for major network carriers is 8.48 U.S. cents compared with 6.09 U.S. cents for low-cost carriers. But the cost per available seat kilometer for major network carriers is 8.4 U.S. cents versus only 4.5 U.S. cents for the low-cost segment. Despite higher revenue, the higher costs of network carriers results in razor-thin profit margins.

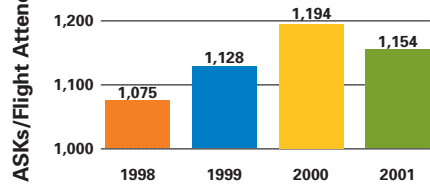
Though established network and flag carriers have an advantage of longer stage lengths and larger aircraft, the production efficiency of low-cost carriers makes it difficult for them to compete in short-haul routes.

And today, low-cost carriers in the United States are beginning to serve long-haul

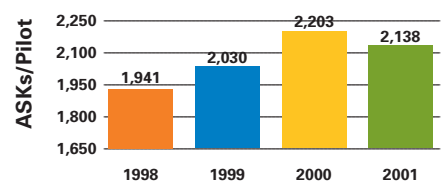
Percent of business travelers in premium cabins, four quarter moving average



Flight attendants productivity increase of 7%



Pilot productivity increase of 10%



Low cost

Characteristics

- Point to point
- Low fare
- High asset utilization
- Basic service
- All private

Peer group

FR, Ryanair
U2, EasyJet
TZ, ATA
B6, JetBlue
AK, AirAsia
DJ, Virgin Blue
WN, Southwest

Majors

Characteristics

- Network (size/density)
- Alliance member
- Local and flow traffic
- Full service
- Some privatized

Peer group

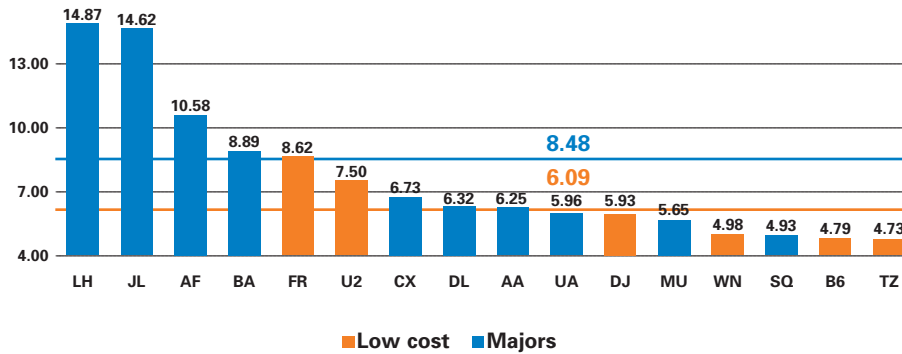
AA, American
UA, United
LH, Lufthansa
BA, British Airways
JL, Japan Airlines
SQ, Singapore
CX, Cathay Pacific
MU, China Eastern
DL, Delta
AF, Air France

Above: As low-cost airlines offer flexible business fares, they cut into a traditional market of mainline carriers — the business traveler. A typical European network carrier experienced a drop of more than 20 percent of business travelers in its premium cabins on short-haul flights from 1995 to 2002.

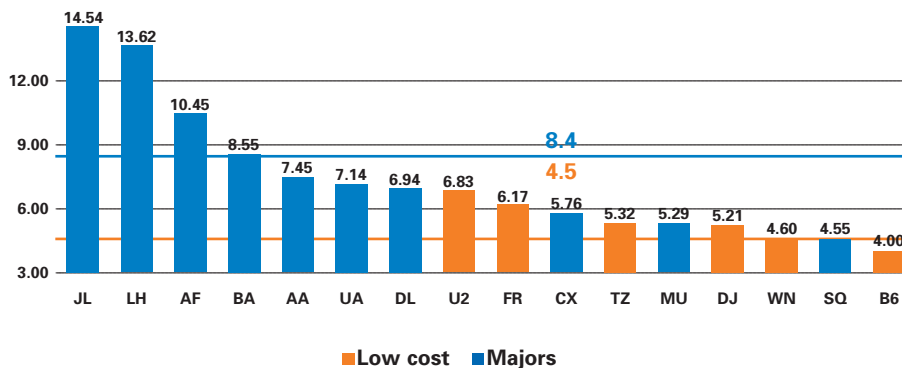
Below: By using integrated production planning and management, AeroMexico has delivered significant benefits, including a 10 percent productivity improvement for pilots and 7 percent for flight attendants.

Left: A peer-group analysis conducted by Sabre Airline Solutions Consulting identified certain traits of major carriers versus low-cost carriers.

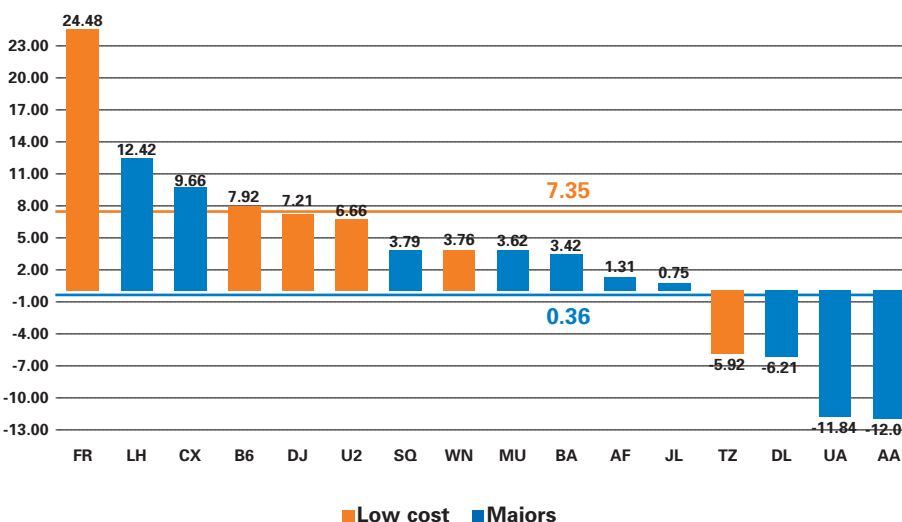
2002 Average Operating Revenue Per Available Seat Kilometer (US\$)



2002 Operating Cost Per Available Seat Kilometer (U.S. cents)



2002 Profit Per Available Seat Kilometer (U.S. cents)



For major carriers, unprofitability is not because they are unable to generate revenue — in fact, the major air carriers earn an average of 2.39 U.S. cents more per available seat kilometer than low-cost carriers — but rather because they have higher costs. Major carriers average operating costs of 3.9 U.S. cents more than low-cost carriers. Because of the cost discrepancy, low-cost carriers average 6.99 U.S. cents more profit.

routes. Southwest, jetBlue, AirTran and America West now fly coast to coast, entering the customary turf of mainline carriers while maintaining significant cost advantages — jetBlue's cost per available seat mile on its transcontinental flights is half that of traditional carriers.

The biggest issue for major carriers is labor costs, exacerbated by complicated work rules designed to maximize the revenues for the workforce, including pilots, cabin crew, ground handling, technical and other aspects of an airline's operation.

The situation for major U.S.-based carriers is particularly difficult. If Southwest Airlines' labor costs were similar to the five largest domestic airlines, its costs would have been US\$1 billion greater in 2002, and it would have reported operating losses of almost US\$600 million. Conversely, if the five major domestic airlines had Southwest's labor costs, operating expenses would have been reduced by US\$9.8 billion in 2002.

Many airlines around the world are striving to transform their business quickly and efficiently. Unlike the many transformation programs of the '90s, the conditions forcing business transformation are much more severe, and the realization has set in among board rooms and leadership teams that carriers must reinvent themselves to ensure long-term survival. The extreme circumstances are forcing airline management to challenge the status quo and accept changes that may have first seemed counter intuitive.

To truly transform itself, an airline must focus on its competitive disadvantages and maximize its natural assets. If a carrier enjoys strong point-to-point tourist traffic and its home airport is strategically positioned for north/south and east/west connecting flows, it can take advantage of both these strengths. It could offer direct services for its prime tourist destinations through a low-fare or charter subsidiary as well as establish a hub operation for the main carrier for key business markets, avoiding the risk of the subsidiaries cannibalizing the main network operation.

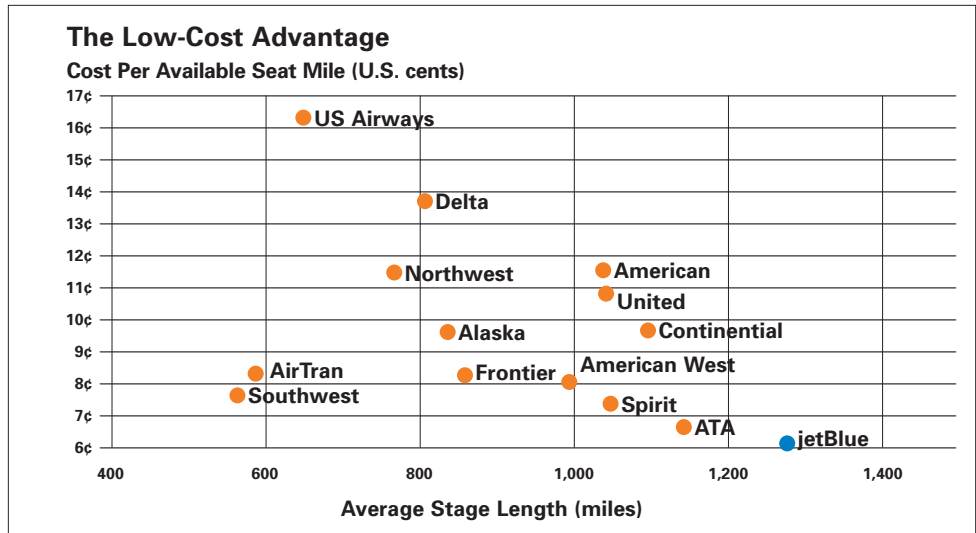
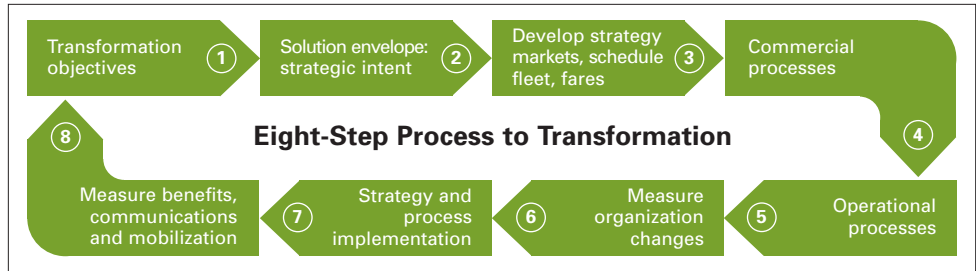
Levels of service also present an opportunity for transformation. Many carriers question whether they should provide full or no-frills service. For price-sensitive, short-haul routes where the carrier competes with low-cost airlines, certain amenities such as first-class seating may not be as important to customers. On long-haul routes where the carrier is likely to compete with other established network carriers, such amenities become more



important; therefore, the carrier can provide low-fare service on short-haul routes to reduce its costs while continuing to provide higher levels of service on longer routes.

The establishment of comprehensive, consistent and measurable transformation objectives defines the strategic intent of the leadership team for the carrier. Executives should seek to change those areas that are ineffective while maintaining those that are time tested and have evolved efficiently through the years. To avoid false starts, the airline should discuss its objectives with its stakeholders to ensure appropriate freedom of action, which will enable the leadership team to deliver the new business model.

The next step in transformation involves strategic market analysis of routes and customer segments. Much of the growth from low-cost carriers comes through stimulating new demand and tapping underserved markets, so assessment of target markets must be much more holistic and strategic. Through a more open, innovative analysis of traditional marketing information data tapes data, a carrier can examine competitor activities and evaluate broader sources of data and information in order to create a more robust route network. Once the market analysis is complete, the airline's network should be restructured. The carrier should focus its efforts on markets where it has a competitive advantage, which for most network carriers includes both domestic and regional markets. Long-haul routes must be analyzed carefully, and where possible, the carrier should take full advantage of codeshare agreements to help reduce operating costs. Revamping the current schedule will help quickly deliver business results.



Top: Through a structured eight-step process, airlines can transform themselves to compete in an altered industry landscape.

Bottom: With costs as much as twice as high as those of low-cost competition, major carriers will have to address the discrepancy by transforming their business models to be more in line with the marketplace.

Traditionally, fleet analysis follows network design; however, to reduce operating costs through fleet simplification, carriers should conduct network and fleet analysis at the same time. While this may result

in some trade offs by not having the optimum-sized aircraft for every market, reduction of the number of different fleet types will reduce staff training and maintenance costs.

THE HIGH-LEVEL view

News Briefs from Around the Globe

Who

Alitalia Linee Aeree Italiane SPA

What

Selected the *Sabre® AirPrice™* fares management system to help maximize its revenues through the tactical and strategic analysis and management of fares.

Why

“We needed to get this capability in place quickly,” said Gianni Matassa, director of pricing, revenue management systems and operations for Alitalia. “Our previous experience with Sabre Airline Solutions proved that they had the experience and

the right technology to get this done. In addition, their end-to-end offering of technology for airline operations ensures that we can have a truly integrated solution — boosting operational productivity and our bottom line.” [E](#)

As part of the transformation, the carrier must also evaluate its processes. If they are too analytical and purely driven by traditional quality of service index techniques, changes must be made throughout the organization to ensure marketing innovation becomes an integral part of the evaluation and overall decision-making process. Some airlines have appointed chief marketing officers to gain a more innovative and holistic approach to market, network and fleet analysis to rapidly transform these parts of the business.

In pricing and revenue management, competitor fares are essential in defining pricing strategies in key markets and determining where fares must be reduced to retain market share. Because passengers have come to expect low fares that are consistent and simplistic, the general trend is to reduce the number of fare classes and eliminate restrictions.

Given that even business travelers are shying away from paying high, last-minute walk-up fares, the focus of revenue management should shift from "revenue protection," where seats are held for last-minute travelers,

to "asset sweat," where airlines sell seats for as much as possible until the plane is full.

Integrated production planning and management offer significant opportunities for cost reduction. Cross-functional commercial and operational teams, including staff from short-term scheduling, operations planning,

methods. With this approach, AeroMexico has delivered significant benefits, including approximately 10 percent productivity improvements in crew, maintenance and fleet utilization.

Transforming the business model by becoming a low-fare carrier, leveraging network advantage or introducing a low-cost subsidiary creates significant benefits that can help traditional network carriers grab and maintain market share that may otherwise be captured by low-cost counterparts. As more and more major network carriers revamp their business model to adapt to a changed environment and meet the demands of today's travelers, the gap between carrier types will decrease, service levels will become a key differentiator between airlines, and network carriers will have as many opportunities for growth and profitability as those currently enjoying them. **E**

The Efficiency Advantage

		Passenger per Employee	Percent Ryanair
Low	Ryanair	9,492	-
Med	easyJet/GO	5,500	+ 73%
	Air Berlin	4,200	+ 126%
	Deutsche BA	3,600	+ 163%
	Germanwings	1,000	+ 850%
High	Lufthansa	1,150	+ 725%
	Alitalia	1,096	+ 766%
	Iberia	996	+ 853%
	British Airways	620	+ 1,430%

Because low-cost carriers such as Ryanair operate more efficiently, as shown by the number of passengers boarded per employee, they have a significant advantage on short-haul routes.

resource management and maintenance planning, work closely together to optimize and reduce production costs. Developing such a "can-do," team-oriented structure drives higher levels of performance than traditional

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hightech

News on New and Improved Products and Services from Sabre Airline Solutions

product

Version 3.0 of the *Sabre LiteVision*® personalized MIDT system

description

The *LiteVision* system helps smaller airlines obtain market information data tapes data necessary for making informed decisions. Utilizing the system, airlines can extract valuable decision-support information from all major global distribution systems' booking transactions.

benefits

The *LiteVision* system enables airlines to minimize data expense, view competitor information, increase revenue and share, and maximize market potential.

features

- **Enhanced reporting** — Airline analysts now have access to six base reports including year-over-year and yield class by competitor.
- **More flexibility** — Airlines now have the choice of selecting 50

markets or going with the traditional top market analysis.

- **Increased market analysis** — The new version doubles the number of markets available for analysis to 50 at no additional charge.
- **Comprehensive data** — Analysts can use the system to study markets based on system-wide or regional bookings.
- **Increased booking share** — The *LiteVision* system can increase booking share on specific markets by 7 percent or more. **E**