

ascend

Taking your airline to new heights

THE POWER OF PARTNERING

A Conversation with
Abdul Wahab Teffaha,
Secretary General
Arab Air Carriers
Organization.



Special Section

Airline Mergers and Consolidation



INSIDE

21

Carriers can quickly recover from irregular operations

46

Singapore Airlines makes aviation history

74

High-speed trains impact Europe's airlines



Low Cost for the Long Haul

Low-cost carriers have transformed the original model by adding ancillary sales and full-service amenities, but can they really make a profit on long-haul flights?

By David Li | *Ascend* Contributor

There's no question the low-cost carrier business model has left a sizeable imprint on the world's air transport industry. More than three decades ago, U.S.-based Southwest Airlines started the low-fares phenomenon with a basic desire to get passengers to their destinations on time and at the lowest possible prices. Since then, the LCC pioneer and largest airline in the United States (based on passengers carried) has paved the way for others to follow suit. But it's not just the LCC business model that has

caught the attention of industry professionals and airline passengers, it's the way the model has evolved over the years. From ancillary sales to long-haul flights, low-cost carriers are consistently pushing the envelope and challenging the norm.

Two or three decades ago, the experience of flying on an airplane was part of the vacation itself. Much like cruise ships, passengers expected quality service from airlines. The U.S. regulatory environment prior to 1978 standardized airline pricing. Thus, air-

lines could only compete through product differentiation: safety, comfort and schedules.

Southwest Airlines was the exception when in 1971, the small Texas-based carrier was bound to fly within the confines of the state. However, because of this inhibition, it was free to set its own pricing. Hence, the company became very disciplined and creative at managing costs, generating ancillary revenue and increasing traffic. The low-cost carrier's perspective was that airline travel was a highly elastic commodity, sold with minimal product differentiation. For Southwest Airlines, its competition was not with other airlines, but with ground transportation in Texas.

As a result, Southwest Airlines became efficient in an area that network airlines had difficulty with — making money on routes that had short stage lengths. Network carriers operated short-haul routes at a loss to feed traffic into their networks and used oversized fleets in doing so. Their network structures meant that many short-haul passengers had to fly an additional four to five hours versus if they were to fly point to point. Southwest Airlines flew passengers nonstop between their origin and destination at fares significantly lower than traditional carriers. It used smaller capacity and homogenous fleet, thereby driving efficiency and cost savings.

In recent years, LCCs such as Ryanair have been innovative in driving ancillary revenue by eliminating the standard airline amenities such as food, beverages, blankets and in-flight entertainment and selling them to customers during the flight. Traditionally, these onboard amenities caused wastage and presented an operation burden for cabin crew. By charging for these items, LCCs were not only able to recover the inherent costs but also create an additional revenue stream. And while Southwest Airlines doesn't allow advanced seat reservations, encouraging pas-

The Southwest Way

Simple Product

- No meals
- Narrow seating (greater capacity)
- No seat reservations, one cabin-class configuration, free choice of seats (fewer passenger delays)
- No lounges

Market Positioning

- Private passengers, holiday travelers, price-sensitive business passengers
- Short-distance point-to-point connections with high frequency
- Aggressive marketing ("flying for fun!")
- Secondary airports
- Competition with all transportation modes (air, rail, automobile)

Low Operating Costs

- Low airport fees and less congestion by flying into secondary airports
- Low costs for maintenance, cockpit training and standby crews owing to homogenous fleet
- High resource productivity: Short waits on ground due to simple boarding processes, short cleaning periods, versatile and motivated staff
- Lean sales (higher percentage of direct sales: Internet, call centers)
- E-ticketing and check in

Southwest Airlines' three-pronged business model is relatively straight forward, with a simple product that is reasonably priced, a strategic marketing plan and minimal operating costs.

sengers to arrive early at the gate to mitigate on-time departure delays, some LCCs have offered advanced seat reservations for a fee.

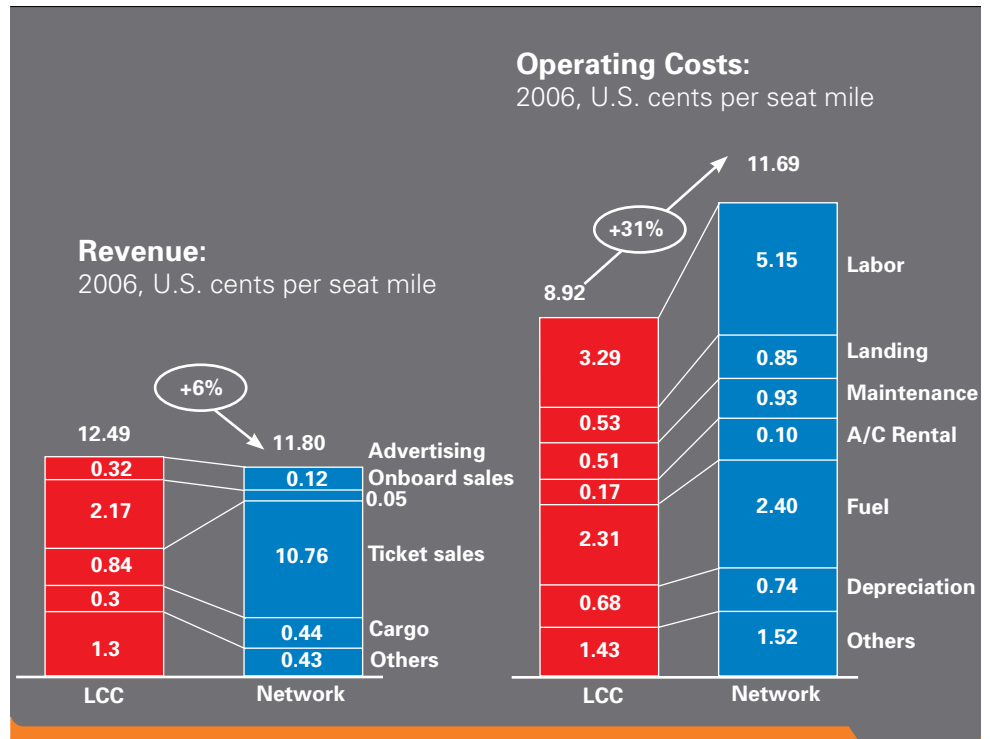
In addition to onboard sales, LCCs have been bold about selling their "in-flight real estate" to advertising agencies. Large advertisements can be seen on the fuselage of their airplanes, on the headrests of seats and on tray rests.

There are other revenue streams that LCCs have found that cater to their existing customer base such as tour sales and phone cards. Regardless, ancillary revenue has increased in its importance and, in some cases, has accounted for up to 20 percent of certain LCCs' annual turnover. As historic yields and profit margins continue to depreciate, it's likely that the industry will become dependent and more innovative in developing ancillary products and services. In fact, some carriers may opt to provide free airline seats as incentives to gain the opportunity for a sales pitch, much like the hotel and resort industries.

Long-Haul, Low-Cost Flights

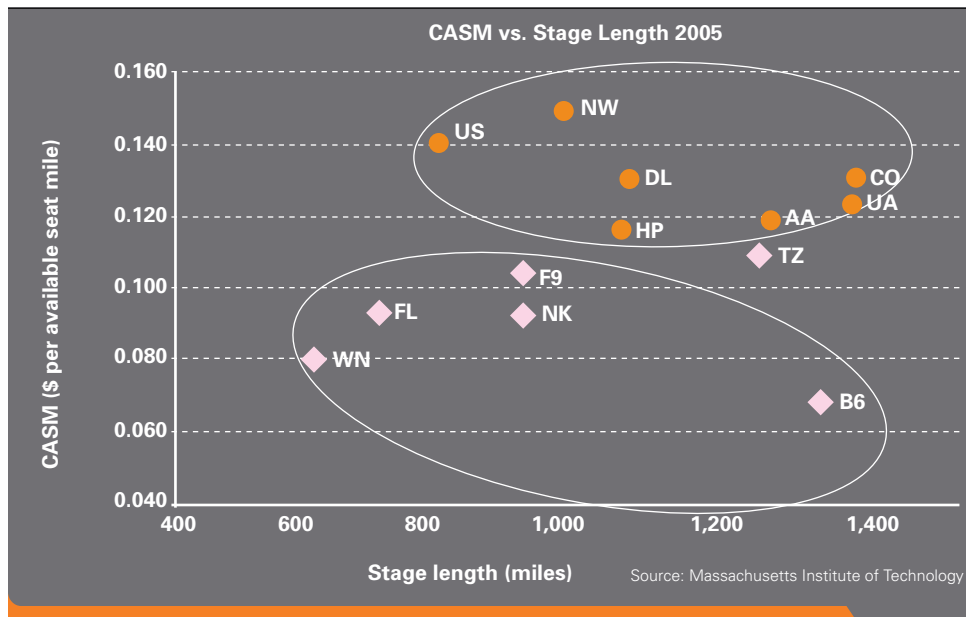
Conventional thought was that the LCC model was applicable only on short-haul sectors because medium- and long-haul segments, with the use of wide-body aircraft, had higher available seat miles that drove down unit costs. Although Southwest Airlines found a solution to a profitless operation (short-haul routes), network airlines had long been operat-

Revenue and Costs: LCC Versus Network Carrier



Though revenue from ticket sales for low-cost carriers is lower than that of network carriers, other revenue channels such as advertising or ancillary sales enables LCCs to have an overall unit revenue to be at least 6 percent higher than network carriers.

Unit Costs Versus Stage Lengths for U.S. Network and Low-Cost Carriers



At nearly all stage lengths, low-cost carriers have a cost advantage over traditional network airlines.

ing longer hauls and, therefore, dominated the niche. Furthermore, frequencies on long-haul sectors were constricted by bilateral agreements, and the routes were reserved for large flag carriers. Hence, the barriers to entry into those international markets were much higher and more difficult for LCCs to penetrate.

However, many regions across the globe have now adapted an open-skies policy, which has increased competition tenfold. Now there's an emergence of LCCs encroaching into new sectors by leveraging their low-cost bases to international destinations.

Low-cost carriers have also acknowledged that while customers may be willing to put up with a barebones product for one to three hours, anything beyond might require a higher level of comfort. Thus, carriers have now started to appeal to the "value-focused" customer, an individual who would seek a product at a level between barebones and full service. This new push to appeal to value-focused customers is evident at several carriers, including jetBlue, which offers free snacks and live television to its passengers; Eos and MAXjet's all-business class, low-fare trans-Atlantic flights; and Oasis Hong Kong Airlines' London, England, and soon to be, Vancouver, Canada, flights with both busi-



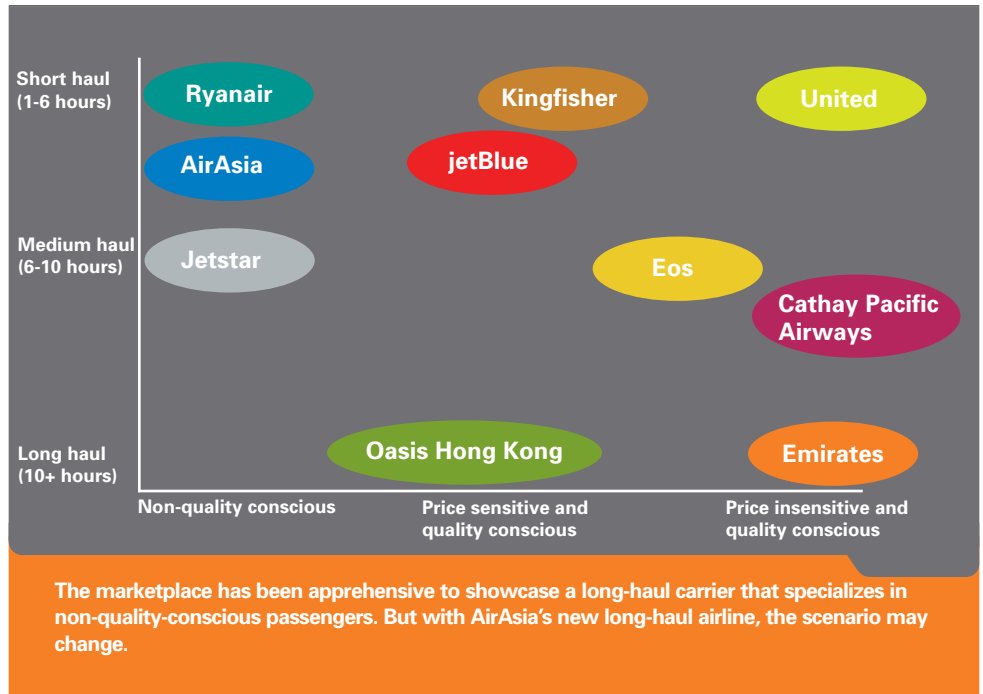
ness and economy cabins that offer a product slightly lower than that of its key competitors, but at almost half the fare.

However, it is difficult to quantify how the marketplace perceives the new value-focused carrier business model. While jetBlue has shown success on the short-haul sector, others have yet to prove profitable on long-haul sectors. Additionally, some low-cost carriers have experienced difficulties generating profits on medium- and long-haul routes because:

- These routes require a much larger catchment area. In some cases, carriers had not made a concentrated effort to generate interline agreements and, instead, relied on local traffic.
- Value-focused carriers offer limited frequency on their routes. For example, Oasis Hong Kong Airlines offers a single daily flight into London Gatwick while British Airways and Cathay Pacific Airways offer three to four daily flights. From a revenue management standpoint, British Airways and Cathay Pacific Airways can match the low fares from Oasis on one of these daily flights and generate higher yield on the others. In addition, Oasis faces stiff competition from Virgin Atlantic, Air New Zealand and Qantas Airways, which also operate the London-Hong Kong route.

A similar scenario can be drawn with MAXjet, Eos and Silverjet on their Washington D.C., and New York trans-Atlantic routes.

AirAsia Flies Long-Haul Routes



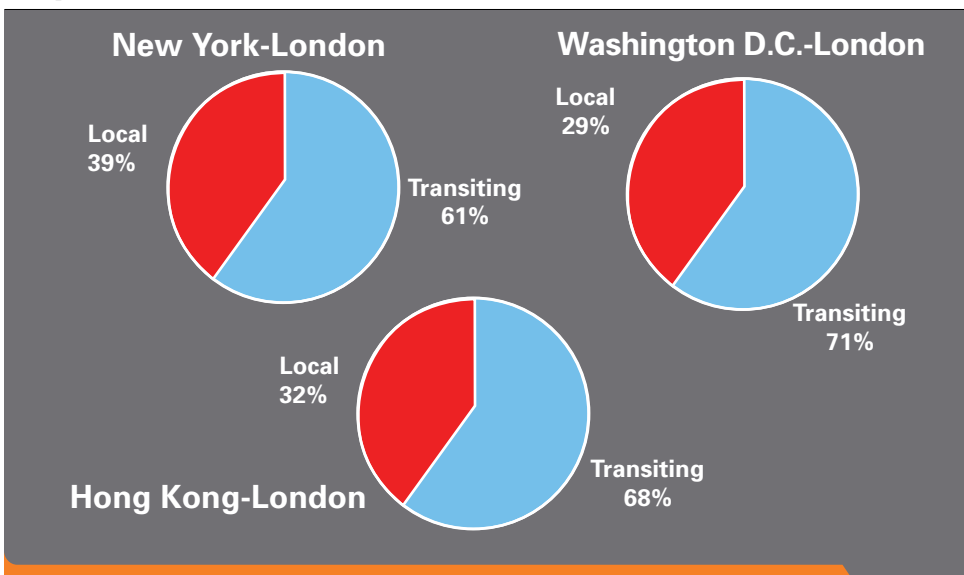
They face competition from American Airlines, United Airlines and British Airways, which have higher route frequencies. In addition, European carriers such as Lufthansa German Airlines can offer high frequency stopover

flights through European hubs such as Amsterdam, Netherlands, and Frankfurt, Germany.

Nonetheless, the market has room for a strict non-quality conscious long-haul carrier. Emirates has mentioned that it could create an offshoot low-cost airline, similar to Qantas Airways' Jetstar Airways, with its new fleet of Airbus A380s flying long-haul routes. Likewise, AirAsia has discussed acquiring a fleet of Airbus A350s to create a long-haul, low-cost carrier that would have a two-cabin class configuration. The product level would be lower than that of Oasis Hong Kong Airlines, but with much greater emphasis for onboard sales.

While the concept of flying long distances at lower prices is possibly quite appealing to air travelers; whether or not it can be done successfully and long term remains to be seen.

Beyond Point-to-Point Traffic



Long-haul travel is dominated by transiting traffic. All markets served by value-focused, long-haul carriers have a majority of passengers with origins outside of their hubs. Long-haul, low-cost carriers will need to focus beyond point-to-point traffic and ensure transiting traffic in their networks.

David Li is a senior management consultant for Sabre Airline Solutions®. He can be contacted at david.li@sabre.com.