

A MAGAZINE FOR AIRLINE EXECUTIVES

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Taking your airline to new heights

EXTREME AIRLINE MANAGEMENT

A conversation with ...

**David
Siegel,
CEO,
US Airways**

INSIDE

Traditional carriers launch
low-fare subsidiaries

How airlines weathered
"the perfect storm"

Cathay Pacific Airways'
crisis management process



The New Revenue Reality

Multiple factors, including the rise of low-cost carriers, fare transparency and diminished passenger segmentation, have put an irreversible downward pressure on airfares.

■ By Steve Hendrickson | *Ascend* Contributor

Lately, most airlines have focused their attention on cutting operating costs, in many cases as a survival strategy. Indeed, several carriers have found significant internal opportunities to reduce expenses, improve efficiencies and lower overall unit costs. For others, cost pressures from external factors such as oil prices, airport security programs and various forms of government taxation have proven more difficult, if not impossible, to manage or influence.

But the sudden focus on belt tightening is merely one of the most visible

reactions to an unprecedented shift in the industry's passenger revenue equation. This "new revenue reality" is driving nearly all of the industry's current efforts to effect dramatic change.

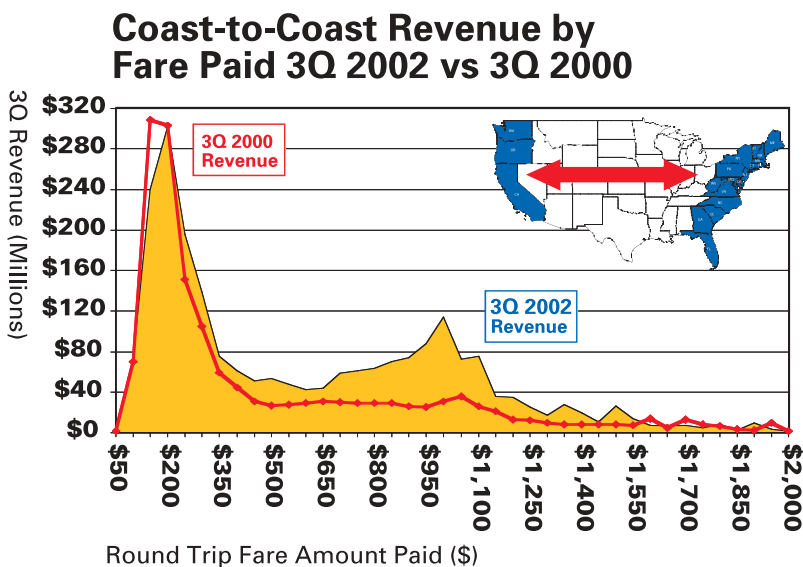
In the U.S. domestic market, total demand as a percentage of nominal gross domestic product fell by more than 26 percent from 2000 to 2002. Historically, the industry's revenues maintained a fairly tight correlation with the broader economy, but clearly, something has changed in that relationship. Contributing to this historic drop is the near disap-

pearance of premium-fare levels historically paid by most business travelers. The two-tiered revenue model of old is rapidly deteriorating, bringing fare levels toward a new, less stratified mix of price points.

The Big Fall

To understand how revenues and average fares fell so far so quickly is to understand the basic remixing of ticket prices being sold to travelers. The market for trips between the east and west coasts of the United States provides a startling example of this phenomenon. This corridor is characterized by a large set of long-haul origin and destination markets, which use numerous competing mid-continent hubs. For example, the Boston, Massachusetts, to Portland, Oregon, market has no nonstop flights, but there are more than 50 daily connecting choices possible in each direction via 18 hub operations offered by seven operating carriers (and even more if codeshare offerings are included).

This type of journey, through any of the largely undistinguishable connecting points, has come to typify the commodity nature of such routes. Up to 2000, significant portions of the market paid vastly differing fares, which reflected strong market segmentation. However, in the past two years, the price spreads have begun to disap-



The average fare among coast-to-coast journeys fell more than 25 percent from the third quarter of 2000 to the third quarter 2002 leading to a drop in revenues of about 29 percent even though the market overall experienced only a 4 percent traffic decline.

pear, moving the industry further toward a commodity market price structure.

The average fare among coast-to-coast journeys fell more than 25 percent from the third quarter of 2000 to the third quarter of 2002. Most strikingly, the volume of passengers at the discount end of the market (US\$350 or below each way) actually increased slightly, while premium-fare passengers (above US\$350 each way) decreased by nearly half. Without those relatively small volumes of premium tickets, revenues plunged by about 29 percent even though the market overall experienced only a 4 percent traffic decline. Although the third quarter of this year saw unit revenues start to improve, those trends were primarily driven by historically high load factors made possible by the cumulative effect of widespread capacity reductions. Unfortunately, there are few, if any, signs of a fundamental reversal in the disappearance of premium fares in the industry.

A Confluence of Factors

It is difficult to blame a single cause for the collapse of the traditional revenue model. Rather, the drop appears to reflect a unique combination of factors all coming into the equation at roughly the same time — what some have called a “perfect storm” hitting the industry. At a high level, these factors include:

- General economic deceleration,
- Increased presence of lower-cost suppliers,
- Fare transparency and Internet-based consumerism,
- Diminished passenger segmentation in pricing.

As it turns out, each of these issues has serious negative implications for total industry revenues on its own, but these issues have proven especially harmful when interacting together. Only one of these, the economy, has

much hope of reversing its impact. The others may well be here to stay.

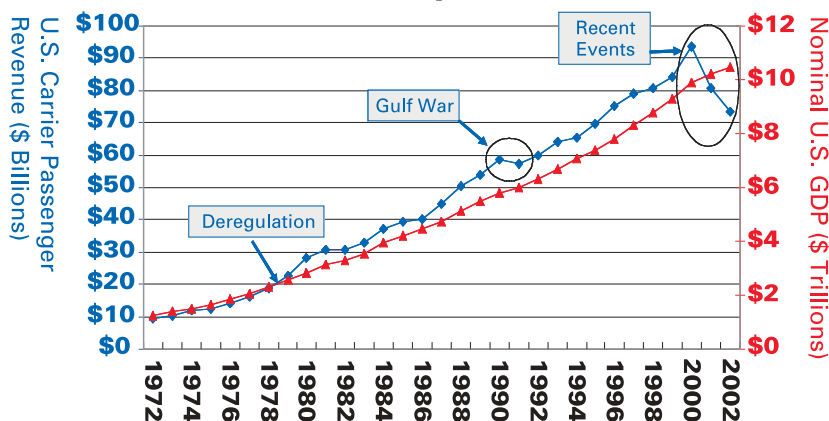
General Economic Deceleration

While economists on Wall Street debate how to describe recent economic conditions, employers and consumers on Main Street largely agree that the good times came to a rather abrupt halt about three years ago. And, that downturn was really felt in early 2001, many months

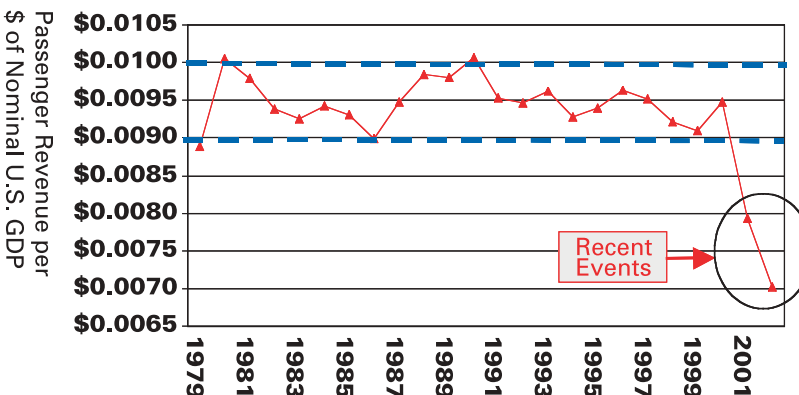
before the tragic events of Sept. 11 gave the industry another push in the wrong direction.

Today's environment contrasts dramatically with that of the 1999-2000 “economic bubble.” During the bubble, a combination of Y2K initiatives and speculative Internet ventures drove a technology-based boom that pushed many business travelers onto airplanes in pursuit of high value, mission critical

Passenger Revenue vs. U.S. Economy



U.S. Carrier Passenger Revenue per \$USD of GDP



TOP: Historically, the airline industry's revenues maintained a fairly tight correlation with the broader economy, but in the past few years this relationship has changed.

BOTTOM: In the U.S. domestic market, total demand as a percentage of nominal gross domestic product fell by more than 26 percent from 2000 to 2002.



deals. Back then, it was almost considered shameful for a dot.com company to show a profit. Venture capital urged the rapid development of alliances and other cyberspace deals to build “eyeball share,” earnings be damned. High demand Web programmers jumped from contract to contract at higher and higher rates, and technocrats everywhere jetted around to strike the next deal — a perfect environment for selling

premium-priced walk-up tickets. The economy encouraged travelers not to worry about saving a few hundred dollars on airfare by driving to a smaller airport or taking a connecting flight for less than the nonstop.

duced another major dynamic to the market’s revenue picture. These airlines have brought low fares into the marketplace in aggressive ways much like early LCCs. However, unlike some of the failed upstarts in prior decades, the newest genre of LCCs have largely avoided many of the pitfalls that rendered their predecessors unable to stay the course.

Increased Presence of Lower-Cost Suppliers

The coming of age of low-cost carriers during the past few years has intro-

Thin capital structures have been

hightech

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

product

Control Center version 2.0 — for reservations and departure control

description

The *Control Center* is a new graphical user interface enabling system administrators to easily configure and manage the *Sabre® Passenger Reservation System*, the *Sabre ACS™* airport check-in system and the *Sabre ACS™* international airport check-in system from a single Web-based tool. The first phase of this interface was released in January, and functionality will continue to be added in phases.

benefits

The *Control Center* enables airlines to focus on managing their operations rather than the systems they are using. *Control Center* creates significant efficiencies for system administrators by providing easy-to-use tools for system configuration, table maintenance and management reporting.

features


■ **Web-based** — Authorized administrators are able to access this tool via the Web with no proprietary client software required and will, therefore, always have the latest version of the product at their fingertips.

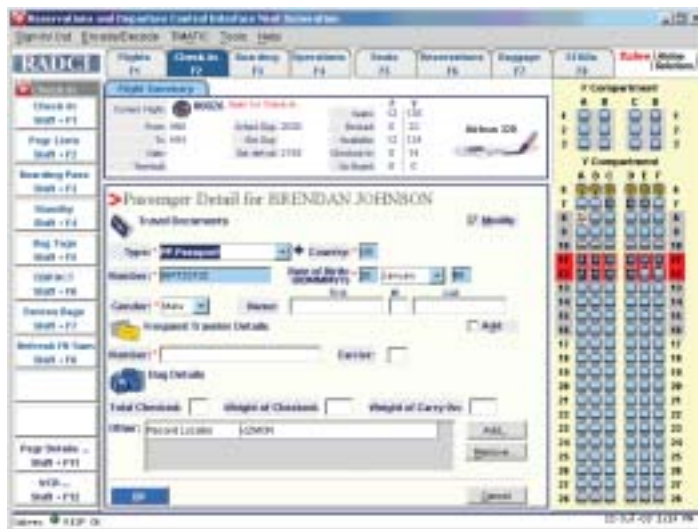
up their partition with increased accuracy. This not only enables administrators to be quickly trained, but it also frees them to utilize system functionality that was previously too cumbersome to set up and maintain.

■ **Direct control** —

Administrators are less reliant on Sabre Airline Solutions personnel for set-up tasks, giving them the ability to quickly adjust to changes in the marketplace.

■ **Single tool** — Administrators will be able to

configure both the reservations and departure control systems from a single tool increasing consistency between systems and in turn improving customer service. 



■ **Graphical navigation** — Administrators utilize graphical navigation such as form-based screens for all entries, drop-down lists and buttons, and on-screen help, to efficiently set

replaced with well-financed business plans. Fleet plans have focused on newer, more efficient models rather than low-priced used equipment. Management teams are still lean but are often populated by more experienced managers than in years past. Software systems and decision-support tools, once practical only for major airlines with large in-house information technology departments, are now available to LCCs, giving them leading-edge technology at cost-effective prices. And LCC strategies have evolved to the realization that, if they stick to their strengths and avoid the temptation to be all things to all travelers or grow too fast, they can maintain their success story. All of this has allowed LCCs to drive price levels down to a point where

their cost structures can survive or even thrive, but higher-cost traditional carriers will be faced with unsustainable losses. As profits accrue for these LCCs, they will become increasingly prominent, creating unavoidable competitive implications for fare structures.

Fare Transparency and Internet-Based Consumerism

Travelers' rapid acceptance of self-service booking engines and fare searches has unleashed a new set of expectations into the market. The fundamental interface between a passenger and an airline's seat inventory has been radically changed. Gone is the 20-question interview conducted over the phone with a travel agent or airline reservations agent.

With the Internet, passengers have a new sense of empowerment to find the bargain they believe they deserve.

Easy, side-by-side comparisons have led to a "shop-till-you-drop" mentality among travelers — "if the fare isn't low, you don't have to go." All of this newfound fare transparency has, of course, only magnified the impact of LCC fare offerings during this period. Likewise, it has helped business passengers understand how much premium they were previously paying for that prime-time nonstop or other preferred service attribute. Now, travelers are armed with information to evaluate the relative cost/benefit tradeoffs represented in their array of ticket options. And the softer economy has made their companies

THE HIGH • LEVEL view

News Briefs from Around the Globe

Who

Bangkok Airways, Siem Reap Airways International, Transportes Aeromar, Aero Continente

What

In June, the four airlines cut over to the *Sabre® Passenger Reservation System*. All four cutovers were accomplished in less than one hour with less than a 1 percent error conversion rate and without disruption to the carriers' operations.

Why

Bangkok Airways — The carrier gained immediate access to "market-leading reservations and departure

control capability" as well as electronic ticketing services, said Ping na Thalang, Bangkok Airways vice president of information systems. The conversion, which also involved its Siem Reap commuter carrier, will also help the airline's domestic and international expansion program.

"We believe that Sabre Airline Solutions offers an excellent product and overall value and a range of technology interfaces that enables Bangkok Airways to continue building its own applications around the host system," Ping na Thalang said.

Transportes Aeromar — The conversion equips the airline with a comprehensive solution for customer processing and service from initial contact to post-travel support. It also upgrades visibility for the carrier's offerings among local

and regional travel agents.

"Our migration will enhance our position as a leader in Mexican regional aviation by delivering a consistent executive world-class product," said Ami Lindenberg, executive vice president and chief financial officer for Transportes Aeromar.

Aero Continente — The conversion offers more comprehensive functionality, lower cost of ownership of its technology systems, access to new sources of revenue and better management of its sales channels and partnerships.

"The agreement with Sabre Airline Solutions satisfies a demand among regional operators who wanted a more efficient connection with the airline systems of Aero Continente," said Milagros Zevallos, commercial director for the airline. [e](#)



more conscious of potential travel budget savings, in turn fueling more bargain hunting and lower price expectations.

Diminished Passenger Segmentation in Pricing

The bi-modal distribution of fares previously seen in a given market was made possible by using fare restrictions as “fences” to segregate buyers of seats based on their respective economic utility. Through a mixture of requirements such as advance purchases, roundtrip travel, Saturday-night stays and non-refundability, the basic fare structure across the industry allowed for price discrimination by passenger market segment. To the extent that competitors were well-behaved within a price leadership model, this structure allowed the industry to become increasingly reliant on a revenue mix that pushed business travelers to higher and higher fares while leisure fare levels remained largely unchanged.


The widening gap became a prime opportunity for LCCs to break from the fare rules model and create a new value proposition for those passengers previously paying premium fares. Now,

in the United States, LCCs (and matching traditional carriers) are offering unrestricted walk-up fares from coast to coast that are far lower than they were formerly, in many cases never exceeding US\$299 each way. New passenger behavior is emerging as passengers are increasingly weaned away from advance purchase habits amid new confidence that affordable fares can be found closer to their travel dates. For many carriers, the booking curve is now shifting closer in and having a dilutive effect on yields for close-in ticket sales. The result has been to radically redefine the revenue value of the business passenger market segment and to reduce overall revenues available to the industry.

A New Revenue Reality?

It’s reasonable to expect the economy to regain strength at some point in the future. There are already nascent signs of a rebound, and many believe that the extremely low-interest-rate environment will induce economic expansion. However, the Japanese economy has had such an interest-rate environment for some time without

the desired impact on the economy. Time will tell, but eventually the U.S. economy can be expected to recover and help lead the global economy back toward a healthier trajectory.

As for other dynamics, there is ample reason to believe that the world has changed forever. The competitive advantages of low operating costs will ensure that a new tier of carriers with lower breakeven price levels will remain a marketplace reality. The new air travel consumerism stimulated by Internet bookings and fare transparency is a trend that will only grow stronger over time. And market segmentation through the widespread use of restrictive “fare fences” will not likely regain its earlier popularity among suppliers and may not find tolerance among a traveling public that has a new set of purchase price expectations. A new revenue reality has arrived, and it will greatly challenge those airlines that do not aggressively rethink their strategies and techniques for managing within it. 

Steve Hendrickson is a partner with Sabre Airline Solutions Consulting.

+count it up

280 — approximate number of airlines that are members of the International Air Transport Association. The IATA members combine for more than 95 percent of all international scheduled air traffic.

2.9 trillion — Number of passenger kilometers flown in 2002, according to the International Civil Aviation Organization. The number is expected to rise to 3.1 trillion in 2004.

1910 — Year of the first major international conference on international air law code. The meeting, in Paris, was attended by delegates from 18 European nations and established several of the governing principles of aviation.

7.3 — Percent of growth for freight traffic during the first half of 2003, according to the International Air Transport Association.

10 — Number of people who have held the title of Secretary General of the International Civil Aviation Organization. Taïeb Chérif of Algeria became the 10th leader in the ICAO’s 59-year history when he assumed leadership of the organization on Aug. 1.