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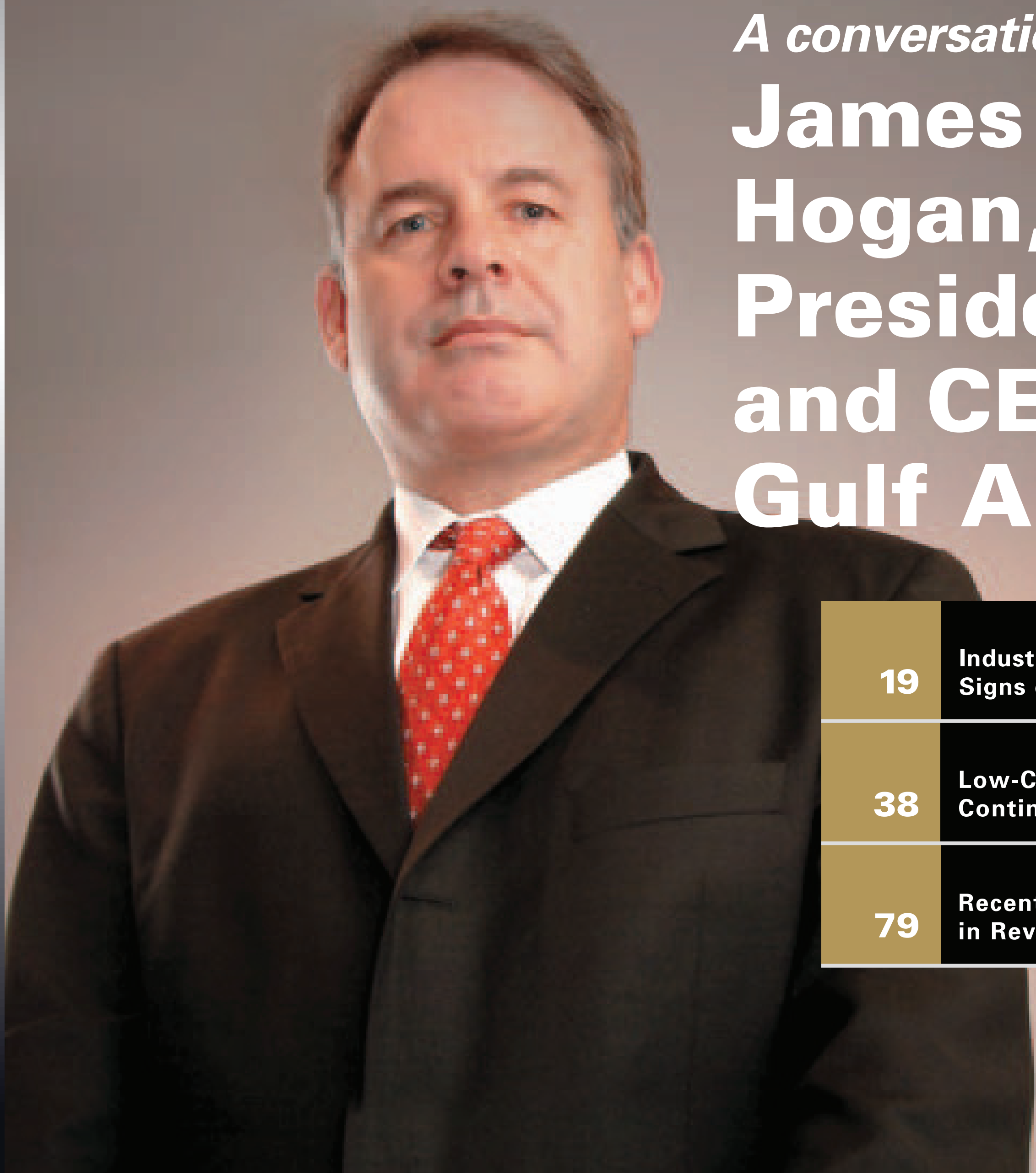
ON THE ROUTE TO RECOVERY

A conversation with …

James Hogan, President and CEO, Gulf Air



INSIDE

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The Revolution's Here

As the low-cost carrier segment continues to grow, it also continues to fragment as new entrants move away from the traditional model, adding new features and customer amenities.

By B. Scott Hunt | *Ascend* Editor

First-class cabins. Assigned seating. Trans-continental flights. Growing hubs. In-flight entertainment. Gourmet in-cabin catering services. International destinations. Mixed fleets.

If this sounds like a list of characteristics that distinguishes the full-service traditional network carrier from its low-cost competition, think again. More and more low-cost carriers — once also called "no frills" airlines — are now adding such features and have, in some cases, led the way in offering additional customer amenities.

Many industry observers believe the low-cost carrier segment is transforming the aviation industry and will determine how — and how quickly — it recovers from the most challenging period in its history. The low-cost segment, however, is currently undergoing significant changes itself, and the proliferation of carriers and variations on the proven low-cost model will undoubtedly affect how the industry will look in the future.

The Origins

In the past few years, carriers in the low-cost segment have begun to deviate from the "pure" LCC model first developed by Southwest Airlines. Southwest has grown to become the sixth largest U.S. carrier — the second largest in terms of domestic traffic — and has maintained profitability for 31 consecutive years by staying true to its formula: mostly short-haul, point-to-point service from secondary airports with a single fleet type; no assigned seating; no in-cabin meals; and onboard entertainment that consists of joke-telling flight attendants and an in-flight magazine.

The model's success spawned a legion of like-minded carriers around the globe: Ryanair and easyJet in Europe, Virgin Blue in Australia, Gol in Brazil and WestJet in Canada are among the most prominent. And their growth and, in many cases, ability to maintain profitability during difficult circumstances has caused the industry to reexamine the way it operates. According to industry observers, low-cost carriers have captured about 25 percent of the U.S. market, 15 percent of the intra-European market, and 30 percent of the Canadian and Australian markets.

But, in the last few years, new entrants in the low-cost arena have also begun to deviate from the Southwest approach. Many

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low-cost carriers had already broken ranks to some degree by offering assigned seating or flying to major airports. But the low-cost segment's "shot heard round the world" likely came in 2000, when start-up carrier jetBlue launched with free live television in every seat. From there, the fragmenting of the LCC model has accelerated rapidly. Frontier Airlines added live TV to its A319 aircraft. AirTran, already featuring a business-class cabin, recently announced it will provide free XM Satellite Radio for its passengers. And jetBlue has further pushed the envelope by adding XM Satellite as well as additional TV channels featuring 20th Century Fox movies, television shows, sports and news programming. The airline is expected to charge about US$3 per movie, enough for the service to break even.

New York-based jetBlue also sent ripples through the industry last June when it ordered 100 Embraer 190 regional jets with options for an additional 100, breaking from the nearly sacrosanct single-fleet-type principle. This year, AirTran also will begin taking deliveries of Boeing 737-700s, complementing its all-Boeing 717 fleet.

Now, even Southwest has said publicly that it is looking at possibly adding new fleet types and in-flight entertainment systems.

What in the name of Herb Kelleher is going on here?

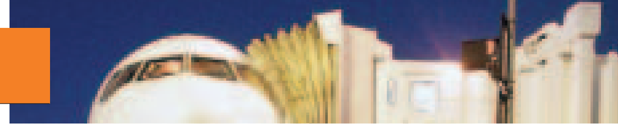
"What you are seeing is an evolution," said Henry Harteveldt, vice president of travel research, with Forrester Research. "It's kind of like the evolution we saw in the auto industry where a budget car manufacturer like Honda has increasingly upgauged the quality of its products. Airlines are recognizing that you have to do something in today's marketplace. The customer will find a better mousetrap elsewhere and will go away."

Making a Difference

Darryl Jenkins, a professor at Embry-Riddle Aeronautical University in Dayton, Florida, said the changes in the low-cost sector are not surprising and are positive for the industry.

"There is nothing sacred about what Southwest does," he said. "I really doubt that in coming up with their business plan that God gave it to them on Mount Sinai and wrote it in stone. It could be deviated from.

"Product differentiation is good," he said. "What made Southwest successful is they had a good idea, which they never deviated from. It is good, but not perfect. Southwest is having its own evolution right now. We see



them for the first time attacking someone's hub in Philadelphia. I think jetBlue's plan is good, but I doubt it is the last one. I see other people doing things that are just as exciting."

The need to differentiate their product is driving airlines to alter the LCC model, Harteveldt said.

"It's just like in retailing," he said. "You have to figure out what can make you different. If you can't compete on price, do you try to go for location? Do you try to go for product?

"The (major) airlines, by failing to really stand for anything in terms of their product or serving a particular customer, have only undermined their ability to compete effectively against the low-cost carriers," Harteveldt said. "If United, American, US Airways, Continental, Northwest or Alaska had really focused on serving a type of customer rather than trying to cover the earth with their service, then perhaps they would have found that people will be more loyal and would pay a premium."

The new carriers, Jenkins said, have a different mindset when it comes to making their product stand out.

"Major carriers differentiated themselves by their networks," he said. "United's network dominated in the Orient. American's network dominated in Latin America. The new guys define their product differently. They define their product as the service you get while you are on the plane. That is a new idea in the airline industry. Before, service was always considered your network."

With that new mindset, then, the new breed of carriers are looking for ways to differentiate themselves by providing the kind of onboard "service" that resonates with their customers.

"I think an airline has to really understand who its core customer is," said Harteveldt. "Instead of 'We serve people in Chicago who want to go to these places.' It has to be more demographic and psychographic — 'We want to serve people who have income levels of 'X' dollars. They take 'X' flights per year.' There are some people out there for whom price is extremely important and always will be. There is no getting around that. You have to ask yourself, as a businessperson, do I want to make those people the focus of my business, or do I want to focus on the people who are going to pay me what I need to be paid, but I am going to give them an experience in return that justifies that ticket price?"

Added Amenities, Added Cost?

Despite adding new features, LCCs still manage to keep costs well under control in order to continue capitalizing on their core advantage — low fares.

"I think it is important to note what these airlines are offering and what they are not offering," Harteveldt said. "It is really putting the emphasis on what the customer wants. And it is also the type of product that does not require a lot of labor. They are amenities that are incredibly extendable. Once you put it in, there is no variable cost. So they scale at almost zero. Once you put live TV in the plane, it's there. It's not like the flight attendant has to go and change the channel or has to change tapes in a video entertainment center.

Photo courtesy of Southwest Airlines

As the low-cost segment continues to develop, more low-cost airlines are beginning to deviate from the "pure" low-cost model first pioneered by Southwest Airlines.

"What the low-cost airlines are doing is putting in amenities that people appreciate and help create loyalty, but do not require human delivery," he said.

Although the added amenities are not driving huge costs, low-cost carriers still face the prospect of rising overhead. In many cases, the low-cost carriers have enjoyed a "maintenance holiday" by flying brand-new aircraft, an advantage that will decline as the fleets age. They also have the benefit of labor pay rates that are significantly lower than the traditional carriers. As the start-up carriers mature, that will also put pressure on labor costs. Southwest flight attendants, for example, recently picketed the airline during contract negotiations as they sought additional benefits.

"Over time, their costs will rise; there's no doubt about that," Jenkins said.

But because they focus on costs rather than revenue, analysts said, they will continue to maintain an advantage.

"The advantage the low-cost guys have is that they concentrate only on having low costs," Jenkins said. "Their low costs translate into low fares, which will bring in the revenue. The major carriers for years have concentrated on revenue, and that (chasing additional revenue) made them high cost."

The Future

The evolution of the low-cost carrier segment is far from over. Already this year, ATA has announced it is adding a business class and company officials have said publicly that it "makes sense" for a low-cost carrier to offer international service, currently one of the last domains of the traditional airlines. Spirit Airlines has already won governmental approval to fly from the United States to 11 countries throughout North America and the Caribbean. And a new low-cost startup, RivieraJet, announced it plans to operate on trans-Atlantic routes.

And those are only the plans that have been announced.

"Since 9/11, I have had over 150 different groups approach me with ideas for new airlines," Jenkins said. "About 100 of these people, I talked them out of doing it. The 50 remaining, 30 will not be discouraged, but I don't think their plans will survive. The other 20, I consider good. Of that, half will get funded. So, there will be a lot of new airlines in the next three or four years."

With the addition of new carriers, and with the cost-cutting traditional carriers in a better position to fight back, competition will intensify in the next few years, Jenkins predicted.

But if the major carriers do not respond effectively, they could be facing an uphill battle, Harteveldt said.

"The fact that they are unwilling to invest in these customer-appreciated and customer-valued products only makes it that much easier for the low-cost carriers to cherry pick more and more people away from the network airlines," he said. "Pretty soon, network airlines will be left only with either the most mileage-addicted customers or bottom-feeders who are just buying strictly on price."

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