Most traditional airlines have lost traffic to low-cost airlines that have experienced high rates of growth over the past five years. Low-cost airlines will be able to maintain high growth rates and could become dominant players over the next five to ten years.

The growing importance of new generation airlines

There is no doubt that low-cost airlines are becoming a dominant force. This is demonstrated by the fact, that in some cases, the capacity (reflective of traffic volumes) of new generation and low-cost airlines has increased by up to three times in the past three years *(see tables, pages 17 & 19)*. This is especially impressive when the effects of September 11th are taken into consideration.

Southwest Airlines, which has been in operation since 1971, has provided the blueprint for all other low-cost airlines, yet they have proliferated only during the past six to eight years. These airlines have made visible changes to the industry in this short period, especially with respect to transparent and simpler fare structures, due largely to the success of the internet. The most notable feature has been their rate of growth and increasing size, both of which have become impossible to ignore.

RASM & CASM PERFORMANCE OF US TRADITIONAL & LOW-COST AIRLINES

Airline	Alaska Airlines	American West	America	Continental	Delta	Northwest
2000						
RASM	10.11	11.33	8.45	10.53	10.31	10.01
CASM	10.18	10.40	8.45	9.82	9.30	9.33
Margin	-0.07	0.93	0.00	0.71	1.01	0.68
2003						
RASM	9.58	9.64	7.93	9.67	9.39	9.54
CASM	9.81	10.11	7.72	9.71	10.02	9.68
Margin	-0.23	-0.47	0.21	-0.04	-0.63	-0.14

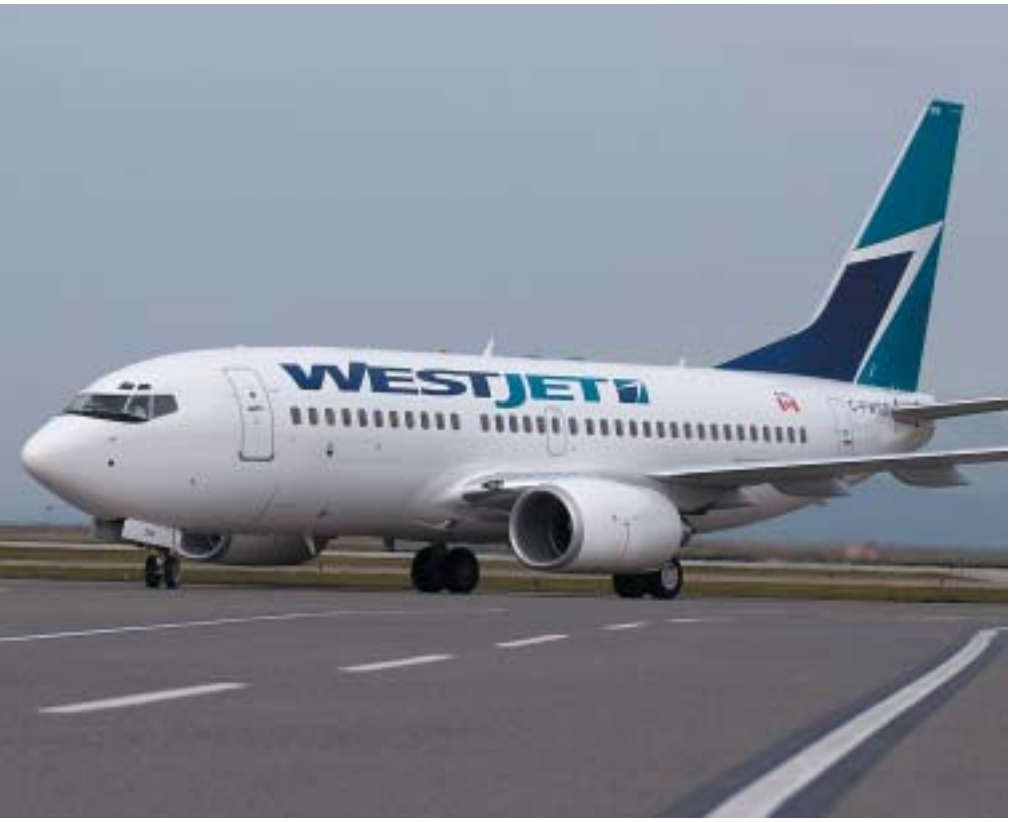
Airline	AirTran	Frontier	JetBlue	Southwest
2000				
RASM	10.65	N/A	N/A	9.43
CASM	9.27	N/A	N/A	7.73
Margin	1.38	N/A	N/A	1.70
2003				
RASM	9.14	7.81	7.32	8.27
CASM	8.28	8.29	6.06	7.54
Margin	0.86	-0.48	1.26	0.73

Industry health

Traditional airlines have based their strategies on high yielding business travellers by developing complex and punitive fare structures, they also incur high cost structures in the process, including high levels of on-board service; business class lounges; providing flight connections and interlining; and offering frequent flier rewards and incentives. Moreover, they have incurred high costs in selling tickets through charges for global distribution systems (GDSs) and agency commissions. High yielding business traffic has also forced these airlines to maintain high staff numbers for the purposes of revenue management, customer services and marketing. The problem with this is that many traditional airlines have passed the point of diminishing returns. That is, the costs required to attract and keep business travellers have equalled or even exceeded the additional revenue generated from them. These high cost structures are also incurred in the long-term, or even permanently.

Attracting high yield passengers has had other effects on costs of operation. "The hub and spoke networks of traditional airlines in the US are inherently expensive, since they minimise aircraft utilisation and require a proportionately high number of staff. Traditional airlines also have multiple aircraft types in their fleets and most business models are inherently expensive," explains David Neeleman, chief executive at JetBlue.

The weakness of the traditional



WestJet has consistently grown at an annual rate of about 45% for the past five to six years, and more than trebled its size from 2000 to 2003. It currently has about 10% of the Canadian domestic and trans-border market, but aims to have 50-60% of this. Current growth rates means it will have to place another aircraft order within the next two years.

airline strategy is illustrated by their historical profit performance. Since airline health is symptomatic of the strength of the economy, airlines have had sufficiently high yielding business traffic in good years, but falling volumes and revenues in years of economic recession. During years of a strong global economy, most traditional airlines have struggled to generate operating profits of 3% of revenue, while making losses of up to 10% of revenue during years of recession. These airlines have ridden a boom and bust wave, with profits in strong years making up for losses of the previous recession, only to be lost again at the next downturn. This indicates an inherently unhealthy industry. The consequences of recurring recessions are felt by all others in the industry.

In contrast, low-cost airlines have shown that even in weak economies their fare structures and rates allow them to maintain traffic volumes, as well as retain a positive, albeit smaller, rate of traffic growth. This has allowed some of these carriers to be consistently profitable. Their profit margins have also been in the range of 8-15% of revenue. This indicates that it is possible for the industry to be financially more healthy.

Unit costs & revenues

The traditional airlines' burden of high costs and weak profit margins is illustrated not only by their overall economic performance, but also by their unit costs over the past few years and how these compare to unit revenues. The margins between unit revenues and costs for most traditional airlines have been slim, which is shown by the performance of some US airlines for 2000 and 2003 *(see table, page 12)*.

The results illustrate the contrast between traditional and low-cost airlines. Although revenue per available seat-mile (RASM) is understandably low due to the effects of 9/11 and the industry downturn, the low-cost airlines still generated positive margins. All traditional carriers made losses over this three-year period. America West had the cost model of a traditional airline in 2001, but subsequently implemented a lower cost strategy and simplified fare structure. The result was a drop in cents per available seat-mile (CASM) from 8.45 cents to 7.72 cents and also a fall in RASM, resulting in a positive margin in 2003. All other traditional carriers have made little impact on their unit costs, although fuel prices were higher in 2003 than in 2001.

Low-cost airlines have lower RASMs but still generate positive margins. In JetBlue's case this exceeds one cent per available seat-mile (ASM).

Losses made by traditional airlines show how susceptible they are to drops in passenger numbers and yields. Besides forcing traditional airlines to maximise their efforts in gaining and relying on high yield passengers, their losses also remove the ability to be flexible in fare pricing structures, and make them susceptible to competitive pressures.

New entrants have only been able to compete with traditional airlines by having greater marketing power and a lower cost base.

Low-cost strategies

The core of low-cost airlines' strategy is overall simplicity: including fare and pricing structures; on-board service; and overall airline operation.

Low-cost airlines have gained advantages simply by offering single-class service, which has increased seat numbers thereby diluting cost per seat. They also operate at uncongested airports, which allow quick turn times and increase aircraft utilisation, with the added bonus of low airport-related charges. While secondary airports may fail to attract business travellers, their low fare strategy does not rely on them.

On-board service is also limited, and allows flight attendant numbers to be minimised.

Many low-cost airlines have also elected to have a single aircraft type, thereby lowering costs of spares inventories. Single fleet types also minimise training-related costs for flightcrew, and operations and maintenance personnel.

Low-cost airlines also outsource the majority of maintenance. They therefore only pay for work done, and avoid the problems associated with labour unions that many traditional airlines face.

Customer service-related costs have also been kept low by a simplified service. Seats are not assigned, reducing check-in and boarding times.

The difference between low-cost and traditional airlines is highlighted by actual unit costs achieved by some of the carriers. "Our unit cost is 10.8 Canadian cents per ASM, while Air Canada's is 16-

18 cents," says Tim Morgan, senior vice president of operations and chief operating officer at WestJet. "We also have a shorter average route length and have been able to reduce our unit cost every quarter, especially when we added the 737-700s. We can keep lowering costs due to greater economies of scale as we grow."

It is in the category of revenue-related costs that low-cost and new generation airlines are making the largest impact, with the aid over the past eight years of the internet. Southwest Airlines has always had a simplified fare structure, but until the advent of the internet still relied on travel agents and direct bookings. The key components of simplified fare structures are a small number of fare categories with small and transparent increases between them, and a policy of offering the lowest fares on a first-come first-served basis. This is accompanied by offering one-way tariffs, and having no travel restrictions.

This has allowed these airlines to lower GDS costs and agency commissions. The internet has been a stimulant in the simplified fare structure product, since airlines have been able to demonstrate the transparency of their fares on their websites, thus increasing direct bookings and reducing GDS costs and agency commissions. By making fares accessible the internet has stimulated traffic. Growth rates for many low-cost airlines have been high over the past three to four years, particularly when the market downturn is considered.

While the internet has lowered the costs of selling and distributing tickets, it has also lowered yields and revenues to a greater degree because increments in fare classes have had to become smaller. The upside is that airlines have been able to increase load factors. This is because the revenue management philosophy differs from the traditional revenue management models by allowing a large volume of low fare classes to be available so empty seats can be sold. Load factors for most low cost airlines are in the region of 85%, and so unit revenue per ASM (RASM) is relatively high and generates respectable margins. Although increasing the availability of low fares results in passenger spill, the low availability of the same fares by traditional airlines means that spilt passengers are not lost to traditional airlines.

The increased access to fare price information and low fares by low-cost airlines through their websites has forced traditional airlines to adopt similar policies. This has brought pressure on them in recent years, and has reduced their unit revenues. Moreover, these new fare structures and yield management philosophies are non-reversible, with a permanent effect on lowering fares. The lower yields now received by traditional airlines are partially offset by the higher load factors they also get due to a changed revenue management structure.

Lower yields

In the past traditional airlines have been able to wait for an improving economy and return of high yield passengers following a recession, but the permanent change in their market is making it difficult for them to return to profitability. The size of the low-cost airlines as a portion of total market volume in the countries where they have been most prolific *(see tables, pages 17 & 19)* means their presence is felt by all traditional airlines across the majority of their route networks.

The traditional airlines are having to find as many ways as possible to reduce costs. This is not so easy, since they have built in infrastructures geared to high yield passengers. High yields are not returning to traditional airlines as they have following previous recessions. Low-cost airlines are able to maintain high growth rates in the meantime, thereby making low fares a permanent feature.

Although low-cost airlines offer low fares, they are not necessarily the cheapest on the market. "We offer low fares, but actually offer a better product and achieve higher fares than most of our competitors," says Neeleman. "As an example we have one-way fares of $100 between New York and Fort Lauderdale, while Song is offering $80. We also have high load factors, so although fares are low our unit revenues are still about 8% higher than the competition. We have some of the highest fares compared to most of our competitors across all of our route network, whoever we are competing with."

Rate of change

The terrorist events of 11th September 2001 had the largest negative impact on airline traffic volumes and passenger yields ever felt, especially in the US and western Europe. The only previous experience of a similar drop in traffic and revenues was during the 1991 Gulf War, after which passenger volumes returned to pre-war levels in six months. Traditional airlines would be particularly

vulnerable after 9/11.

Traffic volumes fell by as much as 35% for some US carriers. The only strategy traditional airlines could adopt was be to cut back capacity by reducing aircraft utilisation and parking others, and then wait for passenger volumes and load factors to gradually return and then increase above previous levels before fares and yields could be raised again. The airlines worst affected would be those with the highest unit costs, and indeed Air Canada, United and USAirways all entered bankruptcy protection sometime after 9/11 while restructuring. Only USAirways has so far emerged from bankruptcy protection, but it still has high unit costs and experiences difficulties. Continental Airlines is the only US traditional carrier that has regained profitability. The airline made an operating profit of $204 million in 2003 on revenues of $8.9 billion. In 2002 it made an operating loss of $312 million on revenues of $8.4 billion.

Major European airlines were also negatively affected by 9/11. British Airways (BA), Lufthansa, Swissair, Air France, KLM, Alitalia, Sabena, Iberia and SAS all saw traffic volumes fall, not only on their transatlantic routes, but right across their networks.

Low-cost airlines in North America and Europe took advantage of the situation and made use of their already-low fares. Albeit cautiously, they maintained capacities immediately after 9/11 and implemented strategies to increase traffic by stimulation with low fares, with the aim of growing their networks and fleets thereafter. This allowed them to take traffic from traditional airlines, making it harder for them to restructure and recover. "We have maintained a 45% annual traffic growth rate in most years, and some markets have expanded ten times. Growth rates were no different after 9/11 than at any other time," says Morgan.

"Traffic growth did continue after 9/11, albeit at a slower rate" adds Paul Tate, chief financial officer at Frontier Airlines. "This continued growth was definitely due to our fare structure."

Traffic growth continued with all other low-cost airlines in North America and Europe in 2002. This contrasts with traditional airlines, many of which had still not reached pre-9/11 traffic levels by September 2002. Total revenue-passenger miles (RPMs) in 2002 for traditional carriers in North America were either less or about the same as in 2001. Air Canada's traffic was down 12.2%, Continental's down 2.9%, Northwest's 1.5%; Delta's was 0.3% higher. In contrast, Southwest, a mature low-cost airline by 9/11, had 2.0% higher traffic in 2002 than 2001, while Frontier's RPMs were up 26.2% and WestJet's increased by 52.3% over the year. The situation in Europe was similar, with BA's August 2002 traffic 10.1% lower than a year before. EasyJet's and Ryanair's 2002 passenger numbers were up 38.6% and 37.8% on 2001.

This trend continued in 2003, with the overall result that the low-cost carriers have continued to grow at impressive rates, while traditional North American and European airlines have changed little in capacity.

The total annual capacity measured in available seat-kilometres (ASKs) for the most significant passenger airlines in the US and Canada, and several European countries where low-cost airlines have proliferated, has been compared over the three-year period between 2000 and 2003.

Since capacity is a reflection of demand, the comparison illustrates how low-cost airlines in these countries have progressed at a rapid rate *(see tables, pages 17 & 19)*.

USA

Capacity offered by traditional US airlines has actually contracted by about 200 billion ASKs, a fall of about 15% *(see table, page 17)*. The biggest falls have been made by Continental Airlines (18 billion), Delta Airlines (51.9 billion), Northwest Airlines (18 billion), United Airlines (77.2 billion) and USAirways (15 billion). The regional carriers that operate for these majors have grown, with a capacity increase of about 26%, equal to 22 billion ASKs.

Over the same period the low-cost airlines (including AirTran, Allegiant Air, Frontier Airlines, JetBlue, Southwest and Spirit Airlines) have seen an increase in capacity of 44%, equal to 53 billion ASKs.

Frontier is the third largest of the new generation low-cost airlines in the US. It started operations from Denver in 1994 with used 737-200s. "From 1996 our strategy has been to operate as a spill carrier, thus carrying low yield traffic left by the majors. We have operated with a lower unit cost and a better product than United," says Tate. "We have added additional frequencies to United's markets from Denver and have based our fares as a discount of theirs. After 9/11 we evolved our strategy to re-brand ourselves as the airline of choice and become the

price leader. We followed this by introducing a simplified fare structure in February 2003. Load factors have since gone up significantly, and annual growth rates have been 35-40% per annum. We are planning for growth of 40% in 2005, and expect 15% per year in the long-term. We will add frequencies and new routes. Our unit costs should also improve, since new routes will increase our average route length. Fuel prices are currently high, but if they were normal CASM will come down to 7.5-7.75 cents over the next 12 months; a reduction of 8-9%. Although unit revenues may also drop because of the longer routes, the margin between CASM and RASM should widen. I do not think the major airlines have the ability to reduce their CASM to anywhere near ours over the next two to four years. They are forced to hope for a return of premium fares, but low fares are now readily available."

JetBlue has been the fastest growing airline in the US. Operations started in 2000 when it was less than one third the size of Frontier. Growth rates have been high, and by 2003 the airline had increased its annual capacity tenfold *(see table, this page)*. The key to jetBlue's success has been to enter markets which had little competition. "We started operations from New York at JFK and identified plenty of markets in the northeastern US that we could go into that had high traffic volumes and fares," says Neeleman. "Our fleet has already reached 57 aircraft. We expect an annual compound growth rate of 26% and forecast our fleet to reach 290 by 2001. Stimulated traffic via lower fares has accounted for the majority of our growth. There are hundreds of new markets to exploit for our A320 fleet, but we have also identified up to 1,000 city-pairs for our ERJ-190s, which will start to be delivered in 2005. The reason for the large number of potential ERJ-190 routes is because the scope clauses the major airlines have with their regional affiliates limit most to 50-seat aircraft. We can operate with a 30-35% lower CASM on these routes. So far our CASM with the A320 fleet has been about 6.08 cents, which compares to American Airlines' 9.75 cents on a similar average stage length. Their unit cost is also after they have made annual cost reductions of $1.8 billion from salary cuts."

Overall, there has been a capacity shift from the major airlines to regional airlines (2.0%), but mainly to low-cost carriers (4.3%) between 2000 and 2003 *(see table, this page)*. Low-cost airlines in the US collectively increased their capacity by 44% over this three year period, with JetBlue having the largest increase with a tenfold jump in ASKs, and Allegiant Air having the second highest rate of expansion.

MAINSTREAM US SCHEDULED AIRLINE CAPACITIES 2000 & 2003

Airline	2000 ASKs-millions	2003 ASKs-millions
Aloha Airlines	2,360	4,320
Alaska Airlines	30,031	34,905
American Airlines	264,195	270,659
America West Airlines	45,901	45,288
ATA Airlines	16,445	27,434
Continental Airlines	141,120	123,309
Continental Micronesia	6,306	5,784
Delta Airlines	240,792	188,864
Song	0	9,055
Hawaiian Airlines	9,921	9,966
Midway	0	354
Midwest Airlines	5,238	5,050
North American Airlines	105	788
Northwest Airlines	168,253	146,550
Pan American	816	550
TWA	61,757	2,919
United Airlines	312,668	235,467
USAirways	97,548	82,912
USAirways Shuttle	2,324	1,319
USA 3000 Airlines	24	1,002
Sub-total	1,405805	1,193,579
Horizon Airlines	3,531	3,582
American Eagle	10,921	12,614
Allegheny	0	1,317
Atlantic Coast Airlines	0	1,142
Atlantic Southeast Airlines	5,491	10,129
ExpressJet	8,102	13,726
Chicago Express	151	509
Comair	7,855	13,496
Delta Express	11,228	4,263
Skywest Airlines	1,626	5,379
Skyway Midwest Connection	3	520
Mesaba	5,524	5,409
Pinnacle Airlines	1,116	4,606
United Express/Atlantic Coast	3,660	6,545
United Express/????	3,248	4,285
United Express/Skywest	2,137	4,185
USAirways Express	9,038	0
Metrojet/USAirways	10,818	0
PSA	0	1,023
Mesa Airlines	2,409	6,289
Chautauqua Airlines	251	5,592
Trans States Airlines	0	2,135
Piedmont	0	1,634
Air Midwest	58	592
Great Lakes Aviation	0	542
Air Wisconsin	0	12
Sub-total	87,170	109,578
AirTran Airways	9,697	16,315
Allegiant Air	99	378
Frontier Airlines	6,680	10,698
JetBlue Airways	2,107	21,459
Southwest Airlines	96,735	116,102
Spirit Airlines	5,738	9,076
Sub-total	121,056	174,029
TOTAL	1,614,031	1,477,186
% majors	87%	81%
% regionals	5%	7%
% low-cost	8%	12%

Regional markets

JetBlue's targeting of the regional market with the ERJ-190 highlights the US majors' vulnerability to competition. Most US majors have pilot union scope clauses limiting the size and number of regional jets their regional affiliates can operate. In most cases all regionals are prevented from operating regional jets (RJs) larger than 50 seats. It was hoped that negotiations with pilot unions in recent years would raise the seat capacity limit to allow the regional affiliates to operate the larger RJs. The main purpose of negotiations with pilots in the major airlines was to achieve salary concessions, and in return mainline pilots have strengthened scope clauses, rather than relaxing them.

It is now more likely that the majors will operate the larger RJs, but these carriers have higher pilot salary scales than their regional partners and this will put them at a disadvantage to airlines like JetBlue. As described, JetBlue has identified up to 1,000 city-pairs that would suit its ERJ-190s. This a fraction of the number of routes served by the US majors' regional affiliates, and other airlines could follow the same strategy as JetBlue, taking a large percentage of the US market from the majors.

Canada

A similar situation has occurred in Canada. In 2000 Air Canada and Canadian were the two major carriers. Together with their regional affiliates, they controlled 92% of ASKs provided by mainstream airlines in Canada (not including small airlines serving remote communities, and charter carriers). At the same time low-cost airlines, including Canada 3000, Canjet, Westjet and Zip contributed 116 billion ASKs: 8.5% of the total *(see table, page 17)*.

By 2003 Air Canada had merged with Canadian and several of their regional affiliates were consolidated into Air Canada Jazz. Meanwhile, Canada 3000 ceased operations shortly after 9/11. Despite merging with Canadian, the capacity offered by Air Canada and its affiliates has fallen by 23 billion ASKs, a drop of 22%, while WestJet, Canjet and Jetsgo have all grown at high rates.

WestJet started operations in 1994 with two 737-200s and first operated point-to-point routes in western Canada. "Canada has mostly small cities with small populations, so we operated at low frequencies at peak times and undercut competitors' fares so they would find it hard to compete with us," explains Morgan. "We entered the eastern Canadian market in 2000 and stimulated demand by offering low fares, but these also allowed us to take market share from the incumbents. We differentiate our services by offering live TV and leather seats. Our traffic growth has always been about 45% per annum and has expanded by a factor of 10 in some markets. We now operate 49 aircraft, including 18 737-200s, and have 54 737-700s on firm order and hold further options. The fleet plan is to phase-out the 737-200s. We could reach a fleet of 94 aircraft by 2008. There is plenty of scope left for growth, with cross-border routes to the US and more frequencies to add in the domestic Canadian market. Our annual revenue is about $1 billion. The Canadian market is about $11 billion, and we are aiming to get about 60% of this. The rate of growth means that current orders will run out in less than four years, so we will have to place another order in less than two years. We want to keep a single-type fleet for as long as possible. We could, however, use larger regional jets for thinner routes, but are also considering the 737-600."

WestJet's capacity increased by about 350% over the three year period. Jetsgo, which started in 2002, quadrupled its size in 2003. The share of capacity collectively offered by these low-cost airlines has increased from 8.2% to 16.7%, doubling their size during this short period. This is one of the highest rates of expansion by low-cost airlines in the world during this period.

UK & Ireland

The situation also has been similar in the United Kingdom (UK) and Ireland, with easyJet and Ryanair both increasing their size by factors of about three *(see table, page 19)*. Ryanair is an Irish company, but has most of its operations from the UK. Combining capacity for airlines in the two countries thus provides an overall indication of the developments.

BA, Cityflyer Express, BA Citiexpress and BA's franchise partners have collectively seen a reduction of about 7.5% in capacity, while British Midland has been one of the few traditional airlines that has managed to increase its size over the past three years. British Midland has always been a lower cost airline, offering lower fares than BA. British Midland's low-cost subsidiary BMI Baby started operations in late 2002 and by 2003 had already become about 40% the size of its parent, providing another illustration of how fast low-cost airlines have grown despite the market

downturn. Virgin Atlantic has, perhaps surprisingly, had a reduction in capacity.

Traditional airlines in the UK and Ireland have experienced a 9.9% reduction in capacity, while low-cost carriers increased capacity by the same amount. Ryanair and easyJet account for most of this shift, although other carriers such as Air Wales, Flybe and Mytravellite also now contribute to a significant portion of the UK's scheduled passenger airline ASKs *(see table, this page)*. Unlike in the US and Canada, the total capacity of airlines has also grown. Low-cost airlines have therefore increased their capacity by an amount larger than the reduction made by traditional airlines.

Germany

Germany provides another example of the success of low-cost carriers. Germany's biggest budget airline Air Berlin accounts for more than half the ASKs of German low-cost airlines, with a growth of 330% between 2000 and 2003. It is now likely to grow further with the demise of Aero Lloyd in late 2003. Germanwings and Germania, although small carriers, have had the highest rate of growth, particularly from 2002 to 2003. Lufthansa and Lufthansa Cityline have in contrast reduced their total capacity by 2.5%, with little change since 9/11.

The share of capacity provided by traditional airlines has dropped by 10%, with this being picked up by low-cost carriers that have collectively nearly trebled their size. Like the UK and Ireland, total ASKs provided by airlines in Germany has increased during the period.

Response to low-cost

The only way traditional airlines can cope with the low yield competition posed by low-cost airlines is to reduce costs more than their revenue has been impacted, while still offering a full-service product. This has been BA's strategy over the past two years, and the airline achieved an annual cost reduction of £760 million ($1.25 billion) from 2002 to 2003, which followed previous cost reductions from 2001 to 2002. "Our main objective is to achieve an average annual 10% operating profit on revenue over the industry cycle. Forecasts in the current year are for this to be 5-6%, but we still have further cost reductions to make," says Martin George, director or marketing and commercial development at BA. "Overall we need to find the premium passengers are prepared to pay for our full-service product. Our yields have been under pressure from low-cost airlines, but we are now getting an idea of the premium passengers will pay for a

MAINSTREAM UK, IRISH & GERMAN SCHEDULED AIRLINE CAPACITIES 2000 & 2003

Airline	2000 ASKs-millions	2003 ASKs-millions
CANADA		
Air Canada	60,656	74,513
Air Canada Jazz	1,747	4,539
Canadian Airlines International	33,399	0
Canadian Regional	3,638	0
Air Nova	63	
Air Ontario	1,173	
Inter-Canadien	92	
Air Transat	4,997	4,894
Air BC	76	0
Air Alliance	1,167	69
Aviation Quebec	3	9
Sub-total	107,012	84,025
Canada 3000	6,278	0
Canjet Airlines	319	997
Jetsgo	0	2,692
WestJet	2,884	10,229
Zip	37	2,899
Sub-total	9,518	16,818
TOTAL	116,530	100,842
% majors	92%	83%
% low-cost	8%	17%
UK & IRELAND		
British Airways	167,372	155,036
British Asia Airways	1,376	0
BA Citiexpress	1,638	3,336
Cityflyer Express	1,391	0
British Mediterranean	1,044	1,774
Loganair	77	122
British Midland	7,349	8,339
BMI Baby	5	3,165
Eastern Airways	53	225
KLM UK	2,066	0
Scotairways	189	165
Virgin Atlantic Airways	35,489	32,672
Aer Lingus	12,197	12,482
City Jet	238	1,191
Skynet Airlines	0	376
Aer Arann	28	264
Jetmagic	10	159
Sub-total	230,523	219,308
Air Wales	0	89
EasyJet	6,059	17,835
Go	4,124	1,850
Flybe	67	2,116
Jet2	0	570
Mytravellite	0	1,539
Ryanair	6,776	20,113
Freshaer	0	286
Sub-total	17,026	44,398
TOTAL	247,549	263,706
% majors	93.1%	83.2%
% low-cost	6.9%	16.8%

full-service product and have stemmed our loss of passengers to the low-cost carriers. We need to reduce costs at the same time to generate a profit. We started two years ago by pruning our network, and made large cuts at London Gatwick, and are also simplifying our short-haul fleet". This is reflected in BA's traffic figures which show a 15% drop in passenger numbers and capacity from 2001 to 2003.

"At the same time we initiated a cost reduction plan. We reduced staff by 13,000 from a total of about 48,000, and gained annual savings of about £460 million ($760 million). We have also reduced sales and distribution costs, which has been aided by an increase in the number of on-line bookings. We have also made a £100 million ($165 million) reduction in procurement costs, and this has totalled £760 million ($1.25 billion)," continues George. "We have further targets for cutting costs, are hoping to take another £300 million ($495 million) out of staff costs. In the past we made losses on our short-haul business, and this was compensated for by our long-haul operations. We are now aiming to break-even on short-haul by the end of 2004, and have introduced on-line booking and a simplified and transparent fare structure".

If BA achieves its cost objectives annual costs should come down to about £7 billion ($11.5 billion). Revenues for 2003 were £7.7 billion ($12.7 billion), and if maintained the airline will be close to generating its target of a 10% operating margin. BA has proved that costs, and particularly staff-related costs, can be reduced while maintaining a full service product. "We have unashamedly copied certain aspects of the low-cost model so that we can lower both our costs and fares," says George. "It is even possible that profits can be made in years when the economy is weak because passengers will not be so price-sensitive to lower fares". If BA does actually maintain passenger numbers in coming years, and other traditional airlines can make the same achievements that BA has, then they will be able to stem traffic loss to low-cost airlines.

Continental has tried to make reductions in a similar way to BA. After 9/11 it furlough 12,000 employees. In 2002 it announced cost saving measures and in 2003 achieved an annual cost reduction of $400 million, although this was partially offset by rising fuel prices. In 2003 it set a further annual cost reduction target of $500 million. This if combined with previous savings and a return to normal fuel prices, would result in an annual cost saving of $900 million. This compares to annual costs of $8.7 billion in 2002, and thus would bring annual costs down to the region of $7.8 billion. Revenue in 2002 and 2003 was $8.4 billion and $8.9 billion. The airline returned to profit in 2003 with an operating margin of $204 million. Indications are that if all cost reductions are made and fuel prices return to normal then operating margin should improve.

Continental's cost reduction measures have included the elimination of paper tickets, more on-line bookings, self-service check-in machines. Although it has reduced staff numbers, Continental has not asked employees for wage concessions. Its is targeting a CASM of 9.4 cents which compares to a current unit cost of 9.7 cents. This compares with a RASM of 9.67 cents for 2003.

Summary

They key is finding what premium passengers will pay for a full-service product and lowering costs that allow a satisfactory profit margin to be made.

Technology from the internet has permanently changed the yield environment for all airlines. It, and other electronic advances, has also provided airlines with the ability to make cuts in distribution and marketing costs, as well as reduce staff numbers in the areas of customer service. The major airlines still have inherent disadvantages to the low-cost airlines in terms of multiple-type fleets and operating from hubs. Major airports are more convenient, however, for business passengers and so attract fare and yield premiums.

Even if traditional airlines are able to find the fares at which their passenger volumes are not eroded and in parallel reduce costs to make a healthy operating margin, low-cost airlines will still stimulate high rates of traffic growth through low fares. While growth rates for some have exceeded 30% in recent years, a compounded annual growth rate of 10-15% will still see these airlines doubling their size in the next five to seven years, and so become industry heavyweights.

There is the additional prospect of some low-cost carriers entering regional markets with large RJs. These markets have effectively been abandoned by the majors. Even if they operate large RJs, rather than their regional affiliates, they will have a cost disadvantage to the majors. There are serious challenges ahead for the traditional airlines. AC