While many major airlines are dealing with the difficulties of high costs and eroded revenues, a few are beginning to realise the benefits of cost reduction and restructuring plans.

How major airlines have turned the tide

Low-cost airlines have been in the spotlight over the past three to four years. Most notable has been their high rate of growth and impressive profit margins. They have also acquired a reputation for putting the major airlines under serious pressure, causing them to lose market share and undermining their profitability. Low-cost airlines, however, are now themselves coming under pressure, as some of the majors have begun to turnaround their fortunes in the past 12 months. Although the industry has had to deal with one problem after another since 11th September 2001, some leading major airlines have been able to restructure, begun making large reductions in their long-term costs, and improve their long-term profitability.

Changing scene

The air transport sector in North America and Western Europe has been forced to make some fundamental changes to the classic airline business model. Major carriers for years have been able to rely on high-yield business traffic, and have geared their strategies and operating models around capturing the maximum number of full fare and high yield passengers. This resulted in US carriers operating hub-and-spoke operations, designed to capture connecting passengers by giving passengers little choice in how they got from one city to another. Some of the disadvantages of this strategy are poor aircraft utilisation and a complicated operation that requires a large number of ground staff for passenger handling.

Another characteristic of capturing high yield passengers has been the lengths to which airlines have been prepared to market themselves. This has involved highly complex and expensive revenue management systems, as well as high rates of sales commission.

In evolving strategies to capture high yield passengers, incumbent carriers have incurred the large long-term costs of a high ratio of staff numbers to passengers, low aircraft utilisation and high sales costs. The overall effect has been to over-complicate the traditional airline strategy.

Operating profit margins of traditional airlines were consequently thin in the best years; in many cases being 2-4% of revenue. Serious problems arose in recession years, when a weak economy saw high yield traffic decline, taking revenues with it. Besides being complicated, the traditional airline strategy's weakness was to incur long-term costs that were hard to reduce. The consequence was heavy losses for most airlines, which then had to rely on a rebounding economy and high yielding traffic before fragile and thin operating margins could return.

The increased presence of low-cost airlines has forced incumbent carriers to make long-term changes to their cost strategies and cost structures. Low-cost airline strategy has combined simplifying the operation as far as possible to generate low unit costs and allow low fares to be offered, to stimulate traffic. Low fares also take market share from the major airlines.

Low-cost airlines in the US have costs per available seat-mile (ASM) that are 20-30% lower than their traditional rivals'. This has been achieved through several means, and includes offering point-to-point services, which avoid the congestion of hubs and the long turnaround times that are a necessity for making connections at hubs. This has raised aircraft utilisation, and all-economy seating has combined to increase aircraft available seat-mile (ASM) productivity.

The simplified service offered by low-cost airlines also removes costs related to catering and passenger handling. Simplified fare structures also allow many costs associated with ticket distribution and marketing to be removed. A major element in the success of low-cost airlines has been their fare structures, which have been aimed at stimulating traffic.

Fare structures & revenues

The traditional airline fare structure and revenue management philosophy was geared to achieving the highest possible unit revenue. This targeted different fares at discrete levels of demand, and was designed to prevent business passengers with a high level of demand from purchasing low fare tickets. This was accomplished by placing fare restrictions, such as minimum stay rules, on the

British Airways has already achieved a real annual cost reduction of £1.1 billion. If it meets further targets, it will have reduced its annual expenditure by £1.65 billion over and above the costs saved from reducing the size of its operation. If it meets this target it should be able to generate an operating profit in the range of 10% of annual revenue.

cheaper fares to force business passengers to purchase high ones. Different fare levels also have different availability levels, so the availability of low fares was limited. This included connecting fares, which were given lower priority over point-to-point fares.

This strategy of deliberately targeting different fares at different demand levels is known as yieldable demand. A further restriction of this revenue management approach was that for passengers to buy return tickets in a particular fare class, that class had to be available in both directions of travel. If a fare class was not available in one direction, the passenger was forced to accept a higher fare class to get a return ticket.

Low-cost airlines revolutionised revenue management by removing all the restrictions of a traditional model. The overall effect of this was to make all fare classes available to potential passengers, and all the available fares visible on their internet booking systems. All fare classes are therefore available on a first come-first served basis. Business passengers can therefore purchase tickets from a low fare class if one is still available. As low fare classes are bought up first, higher fare classes are left. Low-cost airlines have also removed the restriction of requiring both segments to be in the same fare class, so different fare classes can be combined for return tickets. This strategy of increasing the availability of all fare classes to the maximum possible level is known as priceable demand.

Course for majors

The adoption of priceable demand revenue management strategies by low-cost airlines has suited their low unit costs. Priceable demand revenue management models deliberately lower average ticket prices (yields), although they allow higher load factors. Higher load factors therefore offset the effect of lower yields to a degree.

The danger posed by low-cost airlines has been that the market responded well to their revenue management models. Low fares stimulated high growth rates, but also took traffic from the major airlines. Traditional airlines quickly saw their passenger volumes and yields drop as a consequence and were therefore forced to change from yieldable demand to priceable demand strategies.

Revenue management and pricing strategies for most airlines have changed rapidly over the past four years, as evidenced by the reservation systems on their websites.

Major airlines now have to accept lower fares and yields, although this change in strategy has realised some cost savings from reduced sales commissions, distribution costs and less complicated revenue management. The majors have nevertheless seen a net reduction in overall revenue and unit revenue. Some have also seen a temporary reduction in passenger numbers, but they have increased again following the adoption of new pricing, revenue management and reservation strategies. Low fares and revenues can only be sustained if major airlines make cost reductions of at least the same magnitude.

Major airlines do have product advantages over low-cost airlines, however, for which they can charge a premium. These include frequent flyer programmes, membership of airline alliances and extensive route networks from which to choose, interlining between flights and the use of major airports. "These advantages mean we are able to charge fare premiums over the low-cost airlines, but they are not as high as they used to be," says Martin George, director of marketing and commercial development at British Airways. "The market is highly dynamic and these premiums vary periodically. The key to long-term survival is balancing the costs of these extra features and benefits with the lower fares we now have to offer. Although there are 50 low-cost airlines in Europe, the number varies as some wind up operations as others start. A few will be long-term survivors, but few are really big. British Airways (BA) faces two of the strongest in our home market. We therefore had to decide whether we would remain in the short-haul European market, as we would have to be well positioned to do so. We have therefore had to dramatically restructure." This started with BA analysing its whole operation, and the profitability of each of its networks. Costs had to be dramatically reduced.

BRITISH AIRWAYS TRAFFIC, REVENUE & COST PERFORMANCE 2001 TO 2004

Year	2001	2002	2003	2004	Difference 2001 to 2004
Revenue-£ millions	9,278	8,340	7,688	7,560	-1,718
Operating expenses -£ millions	8,898	8,450	7,393	7,155	-1,743
Operating profit -£ millions	380	-110	295	405	
Profit margin	4.1%	-1.3%	3.9%	5.4%	
Passengers-000s	44,462	40,004	38,019	36,103	-8,359
Operating costs £ millions					
Employees	2,376	2,329	2,107	2,180	-196
Restructuring		80			
Depreciation	715	770	734	679	-36
Aircraft lease	221	199	189	135	-86
Fuel	1,102	1,028	842	922	-180
Engineering	662	673	592	511	-151
Landing & user fees	645	615	576	549	-96
Handling, catering	1,303	1,110	961	934	-369
Selling	1,135	824	706	554	-581
Other	739	822	686	691	-48

Reduced revenue

BA started with a restructuring programme in 2001 which has so far seen a reduction in its annual costs of £1.74 billion ($3.2 billion): a fall of 20%. "We were losing market share, mainly to our two big low-cost rivals, easyJet and Ryanair. The only way to stop this was to adopt a similar revenue management and fares policy, and in some cases we have fare classes that match theirs. We can, however, charge a premium with some of the product advantages we have," says George. "The result has been to stop the erosion in traffic and passenger numbers." BA lost more than 4 million annual passengers between 2001 and 2002, and a further 2 million in 2003. "We are no longer losing market share to low-cost airlines, and over the past few years we have increased the number of on-line reservations. Overall, we are back in the passengers' consideration as an airline choice," says George.

The big change for major airlines has been for unit revenues, in terms of revenue per available seat-mile (RASM), to drop. This has been by more than 1 cent in the case of some US carriers.

Comparing unit RASM from the first quarter of 2001 with the same period in 2004, American Airlines has suffered a drop of 1.69 cents, which is one of the largest falls experienced by US majors. Continental has had a drop of 0.99 cents and Delta 0.60 cents. USAirways, United and Air Canada have also experienced falls in unit RASM.

Interestingly, Northwest's unit RASM has actually increased by 1.32 cents. An annual basis may provide a more reliable comparison. For 2000, Northwest's unit RASM was 9.46 cents. This has changed only by 0.15 cents to 9.69 cents for 2003. Alaska Airlines has similarly had little or no change to its revenues.

This illustrates the effect of competition on eroding the yields of American, Continental and Delta in the eastern half of the US, while Northwest and Alaska have hardly been affected.

Although the presence and growing strength of low-cost airlines has been the main reason for this fall, low-cost airlines have also seen their own unit RASM drop over the past three years. Southwest, for example, has seen its unit revenues change from 8.78 and 9.01 cents in the first quarters of 2000 and 2001 to 8.07 cents in the first three months of 2004. It has, however, not made much change to its unit cost, and consequently its operating profit margin has declined from 14.7% of revenue in 2001 to 3.1% of revenue in 2004.

In Europe, BA and other major airlines have felt the drop in revenues on account of increased competition. "Our annual revenue has dropped by £2 billion ($3.6 billion) over the past three years," says George.

Lowering unit costs not only means that airlines will become sustainable in a low unit revenue environment, it also means that major airlines will be able to offer lower fares that are closer to those offered by the low-cost carriers. This should stimulate traffic, and prevent further erosion of their traffic volumes. It also has the effect of making traffic less sensitive to difficulties in the economy, as well as making airlines less reliant on high yield business passengers. Positive profit margins can thus be maintained during periods of recession.

Major carriers do not need to lower their unit costs to the same level as the low-cost airlines. They do, however, need to lower their costs to a level where they can offer fares that include a reasonable premium over the low-cost airlines' fares and prevent traffic erosion, while generating satisfactory margins.

Cost reduction strategies

Most major airlines have few options for reducing unit costs. The main areas for potential reductions are: increasing aircraft utilisation; improving the ratio of staff to passengers; negotiating improvements in staff productivity and remuneration; and reducing the cost of ticket sales and distribution. Other costs can be tackled, including aircraft maintenance, which still has potential for tightening efficiency. Most other aircraft-related operating costs cannot be reduced, and airlines have had to make cost reductions simply to offset the high fuel prices of the past year.

BA has embarked on one of the most ambitious restructuring and cost reduction programmes of all major airlines in Europe. It has aimed to combine this with a new transparent fares structure. "We want to take what the low-cost airlines do well and combine this with what we do well. We started by analysing our operation, and decided to reduce our presence at London Gatwick. The airport is simply not suitable for a hub operation, which is what we were trying to achieve. It was also too close to Heathrow. Gatwick consequently had a low factor and yield problem," says George. "The smaller Gatwick operation accounts for a chunk of our reduction in passenger numbers, revenues and costs."

BA's reduction in its Gatwick operation began in 2001. For the year ended 31st March 2001, the airline carried 44.5 million passengers and had revenues of £9.3 billion ($17.2 billion). This had reduced to 36 million passengers and revenues of £7.56 billion by the year ended 31st March 2004 *(see*

AMERICAN AIRLINES TRAFFIC, REVENUE & COST PERFORMANCE 2002 TO 2004

Year	2002	2003	2004E
Revenue-$ millions	17,355	17,440	18,878
Operating expenses-$ millions	20,685	18,284	18,280
Operating profit-$ millions	-3,330	-844	598
RPMs	121,747	120,328	129,120
ASMs	172,199	165,209	175,241
Load factor	70.7%	72.8%	73.7%
RASM	9.28	9.64	9.70
CASM	10.70	10.11	9.40
Major operating costs $ millions			
Aircraft maintenance	1,297	860	875
Salaries	8,392	7,289	6,819
Aircraft rentals	840	687	675
Other	3,475	3,039	2,810
Fuel	2,562	2,772	3,383
Depreciation	1,366	1,377	1,398

table, page 14). Some routes served from Gatwick were moved to Heathrow, but the airline has reduced its fleet and overall size of operation.

BA's overall aim was to reduce revenues by a higher percentage than the fall in revenue, with a target of achieving an operating profit margin of 10% of revenue. For the year ended 31st March 2001, BA made an operating profit of £380 million ($703 million): equal to 4.1% of revenue *(see table, page 14)*. Revenues have since declined, but passenger numbers and revenues for the year ended 31st March 2004 were stable compared to the previous year.

On the basis that BA's revenues have now stabilised at £7.6 billion ($14 billion), its annual costs would have to be reduced from the 2001 level of £8.9 billion ($16.46 billion) to about £6.8 billion ($12.58 billion). This compares to annual costs of £7.15 billion ($13.23 billion) in the past year, which suggests it has nearly reached its target.

Besides scaling down its Gatwick operation, in September 2001 BA started with a restructuring programme that saw it shed 13,000 staff, taking total numbers down to 47,000, a reduction of 22%. "Although some staff were lost through the reduction of the Gatwick operation, we lost most of the 13,000 through making staff productivity gains. Every area of the airline was attacked," says George. "This initial reduction made savings of £450 million ($832 million)." BA also attacked other cost areas. In February 2002 it announced that it would aim to take out £650 million ($1.2 billion) in its first round of cost reductions. The other £200 million would come from a saving of £100 million ($185 million) saving in ticket distribution and another £100 million ($185 million) from IT procurement. The actual savings were in the region of £870 million ($1.6 billion).

"In 2003 we were committed to a further reduction of about £450 million ($830 million), and we are halfway through this," says George. "The third round of cost reductions was announced in May 2004, with a target of £300 million ($555 million). This last slice will be a further cut from staff costs. The £870 million reduction already achieved, and second and third rounds of cost cuts total more than £1.4 billion ($2.59 billion)."

BA's annual costs have actually reduced by £1.75 billion since 2001, but some of these are related to the downsizing of its operation. Over and above this, it has already reduced costs by about £1.1 billion ($2.03 billion). If the second- and third-tier targets are met, BA's costs will have been reduced by £1.65 billion ($3.05 billion) over and above the reduction from a downsized operation.

The effects on BA's different costs are summarised *(see table, page 14)*. Although employee costs only show a reduction of £196 million, employee and staff costs are also an element of other cost items. The total reduction over the past three years is £1.75 billion ($3.2 billion). Large reductions have been made in the cost of sales, handling and catering, engineering, fuel and aircraft lease rentals. Some of the aircraft operating costs are due to the reduction in fleet size and Gatwick operation.

BA has also improved aircraft utilisation, and made a 20% improvement for its Gatwick fleet, as a result of changing it from a hub operation to a point-to-point service.

"We know the additional costs of having extra features and the benefits of our service compared to the service offered by low-cost airlines, and we have to be sure that we can charge fares to match this," says George. "One strategy we have followed is to develop our fleet so that we use smaller aircraft to block out lower yield passengers. The majority of the passengers we have blocked out are connecting passengers, and so we have been less exposed to the lower yield market. We are now well on our way to reaching our total cost reduction that will allow us to make an operating profit of 10% of our anticipated annual revenue of £8.0-8.5 billion ($14.8-15.7 billion)."

North America

Major airlines in the US have come under the most pressure since 2001, with the rapid growth of jetBlue, AirTran and Frontier, and the continuing expansion of America West and Southwest. Most majors have suffered falls in unit revenue of at least 0.60 cents, but few have have made a real impact on their unit costs. USAirways has emerged from Chapter 11 bankruptcy protection, but has continued to have financial problems. United is still restructuring.

Delta's unit cost, in terms of cents per available seat-mile (ASM), has actually risen since 2001 by 0.22 cents since 2001, and by 1.49 cents since 2001. It experienced a large jump of more than 1.2 cents in unit cost from 2000 to 2001.

Alaska Airlines' unit cost also rose from 2001 to 2004, while Continental and Northwest have only managed to make small reductions. American Airlines is the only carrier to have made a significant reduction, and set about a cost reduction and restructuring programme in 2002. So far it has made an impressive reduction of 1.72 cents in its unit cost,

American Airlines has set itself the target of reducing its annual expenditure by $4 billion. It has already saved $2.8 billion, with reductions coming mainly from cuts in staff and simplifying its fleet structure. These have been offset to a degree by higher fuel prices. American has, however, achieved the lowest unit cost of all US major airlines and has further cost reductions to make.

coming down from 11.21 cents per ASM in the first quarter of 2001 to 9.49 cents in the first three months of 2004.

As with all other major airlines, US majors have had to accept lower yields and unit revenues, and have reduced their unit costs to be more competitive. American's unit cost reduction gives it a lower unit cost than Alaska, Continental, Delta and Northwest. Besides Continental, which is at 9.76 cents, all other majors have unit costs in excess of 10 cents per ASM. In contrast, low-cost carriers in the US have unit costs at least 1.2 cents lower. AirTran is at 8.26 cents, while America West and Southwest are close at 7.59 cents and 7.73 cents. jetBlue has so far managed to achieve the lowest, at 6.08 cents.

Like European majors, US majors have to reduce fares to prevent further traffic erosion. This is only sustainable through unit cost reduction. This implies that most US majors will need to bring their unit cost down to at least the nine cents level.

While it cannot get down to jetBlue's level, American says it can get to within 25%. This implies a cost reduction of about $4 billion from its 2002 cost level of $20.7 billion. Estimates are that it will reach an annual cost of $18.3 billion for 2004, a reduction of $2.4 billion.

Like BA, American can offer product benefits over its low-cost rivals and charge a premium as a consequence. These include frequent flier points, an international route network and different cabin classes.

American's first step towards cost reduction and restructuring was to simplify its operation, which it did by de-peaking its hub and spoke operation at Dallas, Chicago and Miami. This rearranged the flight schedule that allowed the same schedule and operation to be performed with fewer aircraft. American therefore decided to phase out its fleet of 75 Fokker 100s. This is still taking place. In another step to simplify its fleet structure, American also standardised its 767-300 fleet, retired its last remaining DC-10s and MD-11s, as well as the DC-9s and MD-80s that it inherited from TWA. This took the fleet down to seven types, but further reductions are now in the pipeline. Its 767-200 fleet may be shortly phased out, with the aircraft going for freighter conversion.

The reduction and simplification of the fleet over the past two years has resulted in maintenance costs being reduced by about $422 million over the past two years.

Remaining aircraft leases were renegotiated, and lease rentals for 2004 are expected to be $165 million less than for 2002.

American's main cost reduction target was staff-related. The airline negotiated with all major unions and in April 2003 won a consensus to alter pay and working practices that would result in an annual saving of $2 billion. This will be fully realised by the end of 2004, but salaries will have been reduced from 2002's level of $8.4 billion to $6.8 billion: a $1.5 billion drop. The airline has also made some staff reductions since 11th September 2001.

American has also made reductions in other cost areas so total reductions from 2002 to 2004 are now $2.4 billion. The savings from maintenance, salaries, aircraft lease rentals and other costs total $2.82 billion. These and other savings, have been offset by a rise in sales commissions of $300 million and increases in fuel costs of $821 million.

The full reduction of $4 billion has therefore yet to be achieved, but American's unit cost is now the lowest of all six US majors. A return to the fuel prices of 2002 would save American about a further $780 million, taking its current forecast annual cost for 2004 to $17.5 billion. This alone would allow it to generate an operating profit of $1.4 billion on its projected 2004 revenue of $18.9 billion. Its remaining target for cost reduction would be to cut a further $800 million to reach its $4 billion cost reduction goal.

American has already begun to realise the benefits of reducing its cost base. It was the only US major to make an operating profit in the first quarter of 2004, traditionally a weak period for all airlines. Projected profit for 2004 is about $600 million. This compares to a loss of $844 million in 2003, and $3.33 billion loss in 2002.

On the basis of a drop in fuel price from 102 cents per gallon in 2004 to 83 cents in 2005, American is forecast to generate an operating profit of $1.07 billion in 2005, which is equal to 5.3% of revenue.

American's first quarter traffic grew by 8.8%, indicating that its strategy of removing fare restrictions and making fares more accessible on its website has helped stimulate passenger numbers. Unit revenues also increased by 5.2%, but mainly due to a higher load factor.

Summary

BA and American have certainly demonstrated that they are capable at making more than superficial reductions in their costs. The majority of these have come from salaries and improvements staff efficiency. Although these are not easy to negotiate, other major airlines will have to follow BA and American because high cost bases are not sustainable in the new low-unit-revenue environment. A few major carriers have stopped loss of market share to low-cost airlines, and BA and American are regaining their status. AC