High fuel prices, falls in premium passenger traffic and a drop in airline revenues have compounded for LCCs and FSCs to moderate the extremes of their business models. The distinction between their strategies and costs has become blurred, and hybrid airlines are emerging.

The advent of the hybrid airline model

Plummeting passenger numbers and revenues, and fast-rising fuel prices have pushed airlines into an era of identity crisis. The 'Low-cost'/'full-service' distinction is looking more like the distant ends of a spectrum, and airlines are moving towards the middle ground. There is now the prospect of 'hybrid' airlines, with a mix of strategies. Each airline strategy extreme is innovating to survive by adopting 'best practice' features in a pick 'n' mix fashion, and experimenting with various revenue management (RM) techniques and ancillary revenues. Low-cost carriers (LCCs) and full-service carriers (FSCs) are having to develop new strategies to ensure long-term survival.

Converging strategies

Airlines from different parts of the spectrum, including LCCs, are starting to codeshare for greater reach and brand awareness. In short, the hybrid carrier revolution is gathering momentum, but it is the legacy full-service carriers (FSCs) that are struggling most. Premium traffic has evaporated following the credit crunch, just as low-cost carriers (LCCs) are finding ways to get their own premium traffic, amplifying the problem.

The Centre for Asia Pacific Aviation believes that "there are unprecedented numbers of airlines flying today with badly broken business models. Premium travel has collapsed and there are now fundamental questions being asked about the timing and extent of the recovery." It adds that "the current Northern summer peak is masking many of the deep structural flaws besetting the industry."

That the problems go to the fundamental structure of airlines and the industry means that airlines are having to do more than simply cut costs to survive. They must innovate to stop their aircraft flying half empty, at least at the front.

Serious restructuring and drastic steps are being taken by a whole range of major airlines, including BA, SAS, Gulf Air, and SIA. Carriers such as AirAsia and WestJet make life harder for the big airlines by starting to become more sophisticated, doing more for business travellers and offering value by allowing passengers to package things together themselves.

IATA's June Premium Traffic Monitor noted that the decline in traffic had 'moderated', but that the stabilisation was being achieved partly "at the expense of much lower yields, as airlines seek to boost cashflow by making more cheaper seats available. Revenues from premium traffic fell an estimated 33% in the first quarter of 2009, and by 41% in the second quarter. It was still declining at a rate close to 40% in June."

One of the big problems for the industry has been the speed of the decline. With aircraft manufacturing, it takes a long time to ramp production up since it brings an entire, worldwide supplychain with it. It cannot be put on hold overnight. Similarly with airlines, they do not want to simply ground aircraft. They risk losing market share, and aircraft conditions and values will deteriorate when they are idle.

Unbundled service

Allessandro Ciancimino, vice president at Sabre Airline Solutions says: "What we have seen over the past few years is a definite trend for airlines going towards unbundling the full-service product offering, and letting the customer buy the seat and then define what extras they want."

Sabre was acquired by Texas Pacific Group and Silver Lake Partners in 2006, just after it had acquired Lastminute.com. Sabre already owned Travelocity.com. That Sabre Holdings owns these on-line retail outlets as well as its core GDS division, Sabre Travel Network, is indicative of the growing importance of airlines maximising revenues from various sources. Sabre Airline Solutions is the third arm of the business, advising airlines in a consultancy capacity.

Ciancimino says that the danger for airlines in unbundling is that they cannot predict how many customers will simply purchase the core product, the flight, and nothing else. In addition, following unbundling there is the danger that those willing to pay higher fares may not be the ones that are likely to purchase ancillary products, so that the revenue ends up being less. "So you may have more customers but less revenue," says Ciancimino.

"So this is why there are a couple of things airlines are putting in place; ancillary revenue and items unbundled as options. Airlines used to offer only instant ticketing on-line, but now some are offering the option to pay to hold the booking for 48 hours. Vueling of Spain is one example," explains Ciancimino.

"You can offer different items on board, or extra baggage or lounge access, or a limousine. These put challenges in the way of how you manage inventory. The more you unbundle and the more ancillary items you have, the more traditional 'revenue management' becomes obsolete," says Ciancimino.

Real-time RM

With the fare becoming a smaller proportion of the revenue, down to about 50%, it is a very different optimisation challenge, since it depends on customer behaviour.

"This is where we are at the leading edge as RM moves towards focussing on three things," says Ciancimino. "These are: the RM on the total revenue collected; forecasting what is the average

FSCs have found that if they play their strengths correctly they can combat competition from LCCs. FSCs have the advantages of schedule frequency, premium cabin classes and lounges, frequent flyer programmes, interlining with larger route networks and higher in-service standards. FSCs do not have to match the LCCs' fares, but just be value-competitive.

ancillary revenue average per passenger or passenger flying on each fare; and being able to do 'real time' RM."

The third aspect has come about because, with demand now changing dramatically, data of previous trends is not so worth analysing as it was previously. This was when markets were mature and predictable. Monitoring what is happening today is now de rigeur. "You need to base decisions on quasi-real-time information. This is exactly why we started working on these concepts a couple of years ago; RM based on total revenue," says Ciancimino, who adds that some carriers are much more advanced in this respect. "Very few are really up to speed with the processes though," he says. One problem is that most LCCs do not have an understanding of who is travelling and why.

Westjet and jetBlue are examples of carriers which have started to do RM based on total revenue. "The US is leading because it entered the recession first, and also the US traditionally leads the way driven by the need for profitability when there is lots of capacity and lots of competition," explains Ciancimino.

Airlines in the rest of the world are moving towards the 'hybrid' model too, increasing the customer base by offering products that can attract higher yield passengers. "To do that you need to complicate your model, and distribute it via a GDS. easyJet and Air Berlin are doing this, trying to be more sophisticated and also trying to steal business from the majors (for example Lufthansa)."

Ciancimino agrees that the next stage is codesharing. "Airlines such as Southwest said that they would not codeshare, but now they are, as are jetBlue (with Lufthansa) and Canada's WestJet. It complicates the product, but allows for greater reach without any investment," he says. "The low-cost and full-service carriers are both converging towards a hybrid, but the difference is that low-cost carriers start from a much healthier cost structure. It is harder to start as a network carrier because it is still a different culture."

Ciancimino points to Alitalia, which has a fresh start, having shut down the legacy carrier; and similarly with Olympic Air. "At some point BA needs to make radical changes too. It relied on high-yield business traffic, which has evaporated."

Such passengers are likely to come back far more cost-conscious and will have learned that they can fly business class with much cheaper fares. This will drive consolidation.

The other problem for legacy carriers is that long-haul routes cannot be sustained purely with point-to-point, because it needs an effective feeding structure. So codesharing with regional and low-cost airlines allows airlines, such as Lufthansa, to get that revenue.

LCCs eye travel agents

Cyril Tetaz, head of airline distribution marketing with Amadeus, says that all airlines are now trying to better utilise the travel agency channel, which "requires a different approach". Travel agents represent 55-57% of revenues for full-service carriers (FSCs), and these bookings provide far higher yields than airlines can get on their own websites, says Tetaz.

"In 2008 we estimated that on average an airline would get $100-150 in revenue on a typical route, such as Madrid-London. For offline (travel agency) the yield is more like $264, so close to 80% higher," continues Tetaz. "This is driven mostly by business customers, which tend to book later than leisure travellers and want more flexibility. So when premium traffic is 20% down, that can represent 60-70% of your bottom line, which is a big impact."

Tetaz says that the industry is not sure whether these customers have stopped travelling or have moved to lower cost options but," he says, "the big debate is will they come back when there is an upturn?"

It is surprising to note that on-line travel agents (such as Expedia) are providing yields of $206 on average, according to Amadeus, which is significantly higher than airlines are achieving through their own websites. This channel represents 10% of total ticket sales worldwide; 210 million bookings in 2008.

"Ancillary revenues are increasingly important. Airlines are relying on them to upsell by giving customers more value. The best-in-class low-cost carrier can get up to 25% from this. Allegiant in the US is the leader, while Ryanair is at 20% and easyJet 18%; having been at 11% only one year earlier," says Tetaz.

"To get this you need to maximise the capacity to extract revenues while the passenger is on the website," adds Tetz. This is becoming increasingly important as the pure fare revenue becomes less and less able to cover operating costs; something of a vicious circle. This relies on dynamic packaging. That is, being able to include offerings from third-parties as part of their booking process, as an integrated whole.

"Everyone is looking at unbundling, charging for bags for example, and everyone is looking at ancillary revenues too. It is not rocket science, but can paradoxically become a very complex topic. Full service carriers are at only 3-7%. American Airlines, Qantas, and United Airlines. This far lower than the LCCs.

"For LCCs to utilise the travel agency channel will require a lot of effort," continues Tetaz. "You have to make it as streamlined and easy as possible for travel agents, and low-cost airlines will have to find a way to incentivise the channel."

"Vueling is an interesting case," says Tetaz. "Close to bankruptcy a year ago, it started a turnaround plan in May, and leveraged the travel agency channel. The results are really impressive. It operates nine flights a day between Madrid and Barcelona, which one of the top 10 busiest routes in the world, and has 40% corporate customers."

Vueling started to run a hybrid business model. It is ticketless for the on-line channel, while allowing BSP and ticketing for the off-line channel. Then, by cutting unprofitable routes and increasing frequencies on key commuter or business-focussed routes, the low-cost carrier, launched in 2004, increased revenue per flight by 22.8%. Travel agency revenues now account for 18% of Vueling's total ticket revenue.

easyJet has done a similar thing, and even offers a fully flexible fare now. This is very much an RM technique that is normally a feature of marketing to business travellers. "We are now getting lots of interest from LCCs wanting to know how travel agency distribution works," claims Tetaz. "But LCCs must understand bookings, the travel agency mentality and the available solutions. Some LCCs such as Air Berlin are already operating exactly how a FSC, such as Air France, would operate when it comes to using travel agents," he points out.

"It is a fascinating time," believes Tetaz. "The movers and shakers are going to come out with the opportunity to be stronger, but they will first have to revisit their business model assumptions, and address the dogma of the LCC. FSCs will have to be more aggressive, but more transparent."

Legacy challenge

Michael Cox, managing director and head of corporate advisory at Seabury Group, says: "We are not seeing FSCs turning into LCCs, but all airlines are looking for all ways to improve revenues. Southwest, for example, is charging $10 extra for a passenger to go to the front of the check-in queue."

Cox points out that the sharp decline in premium traffic is very significant because it was a huge multiple. There has been a debate for years about whether or not the front end of the cabin subsidised the back end, or vice versa. But it is a balancing act really.

Recently there has been a trend towards discounting premium fares, says Cox. "Recently I flew from the US to London, booked business class the week before. I was not even staying a Saturday night, and it was $2,200."

At the same time legacy carriers have had to further cut costs. In the US the cost gap has converged for two reasons, says Cox. The first is that legacy carriers are using bankruptcy protection (or the threat) to negotiate labour costs. Second the LCCs have been flying longer sectors, making it more difficult to maintain a premium and forcing further cost cuts.

Long-haul is a double-edged sword for LCCs, however. "For years the Southwest model was to undercut legacy carriers on short sectors, which meant having a lower cost per available seat-mile. On longer sectors the flight is inherently lower cost per passenger sear-mile," says Cox. "It is therefore harder for the LCCs to compete on longer sectors where the 'no frills' elements account for smaller proportions of the total sector cost. A good example is the Atlantic. How much cheaper can you get than $500 return fare on a legacy carrier?"

Another issue is the threat to LCCs in the short-haul market. "You can probably count the number of pure low-cost carriers on one hand. The only real one in Europe is Ryanair, and even it is starting to deviate," says Ciancimino. Ryanair now flies some 3-4 hour sectors in an attempt to sustain the sustained growth that its business model relies on. These sector lengths are way beyond the

short legs Ryanair once said it would stick with.

Cox says that for FSCs to survive they need to play to their strengths, such as frequent flyer programmes, assigned seating and meals. "When all else is equal, customers will prefer this. I used to work at Continental and we realised that if you could compete with the LCCs on schedule and be competitive on price, your flight would be chosen for two reasons; the chance of an upgrade, and to collect frequent flyer points. The business traveller chooses schedule over price, so you do not have to match LCC prices, but just be value-competitive."

Legacy carriers have "absolutely got smarter thanks to LCCs," continues Cox. "They are learning from each other and this has caught some other airlines in the middle. We recently advised Frontier (before it emerged from Chapter 11), which was squeezed at the top by United and below by Southwest. It realised that costs would have to be lower because its revenue was effectively capped by United at its Denver hub.

"It was not able to find that extra full-fare passenger because it did not exist," continues Cox. "So it cut costs further, including labour, which was painful. Now it has made money for eight months in a row." I believe that airlines need to accept that premium traffic may not come back and so they should prepare for the worst, and cut costs. This is the new world.

"Allegiant is a different kind of airline," continues Cox. "It has maximised the synergies between the hotel business and destinations, such as Las Vegas and Phoenix. These are cities with enough traffic for it to create a monopoly. An example is Abeline, Texas to Las Vegas. But at the moment it seems when it comes to the U.S. market, everyone is talking about Allegiant."

What is 'low cost'?

'Low-fare carrier' is how many now prefer to call airlines with a low-cost model, but what is the 'fare' when increasingly it is different for every passenger? It is easier to talk of low-cost because the ingredients are the same in the 'pure model' invented by Southwest. These are a single aircraft type with high-density, all-economy seating, return-to-base at the end of the day, and extra charged for food and drinks.

Crews work harder for less, in terms of their total package, and fewer cabin crew are required. The so-called FSCs, however, have recently been busy cutting back on catering on short-haul routes.

Passenger handling is streamlined for LCCs, although some have been moving to assigned seating, especially where they have been targeting business travellers.

Aircraft utilisation is another area that has wrong-footed legacy carriers over the past decade, as LCCs have shown how hard aircraft can be worked. Comparing utilisation of A320s using the ACAS aircraft database, it can be seen that jetBlue has managed an annual average of 3,888 flight hours (FH) and 1,422 flight cycles, while Jetstar Asia has managed 4,000FH, even with shorter average FC times. Ryanair averaged 3,500FH with its 737-800s. In contrast Lufthansa recorded only 2,244FH, KLM 2,188FH and BA about 2,500FH. Interestingly, Air Canada has managed well over 3,000FH with its A319 fleet, although this at an average stage length of 2.96FH. Aircraft utilisation is certainly not as black and white as when the LCC revolution began 10 years or so ago.

Consultancy IBA believes that LCCs may have a challenge of their own, however. "Ryanair could come unstuck with its policy of selling aircraft at year six, since they are not taking into account the heavy checks, which can cost $5 million," says IBA managing director Phil Seymour. "BA meanwhile, is still doing the 'non-mandatory' work, because it knows it will be keeping the aircraft."

"We do not currently put a value degradation on, but I think it might

Spanish carrier Vueling is an example of an LCC that now runs a hybrid strategy model. It distributes through its own website as well as travel agents, and has increased its network frequencies. It now attracts a high number of business passengers, and is consistently profitable.

come. We would need to factor it in if it is not in their cost per FH," adds Seymour. "Ryanair could come unstuck if the recession continues beyond another six months or so."

DOC difference

The growth of LCCs over the past 10-15 years has followed from a clear model of low unit costs per available seat-mile. This has allowed LCCs to offer low fares and stimulate passenger demand. The low-cost model also made a clear distinction between LCCs and FSCs. The low-cost model had several main characteristics. These include high seating densities, high rates of aircraft utilisation and low fuel prices. Fuel prices have clearly increased, and the gap in rates of aircraft utilisation between LCCs and FSCs has closed in some cases. There are other aircraft-related costs where LCCs were able to achieve lower costs per seat and ASM than FSCs.

There is also the issue of non aircraft-related costs. These include: costs of passenger sales, passenger check-in and airport handling, ground handling, airport passenger charges and tariffs, ground handling for the aircraft, aircraft landing and parking fees, en-route navigation charges, outstation crew hotel costs, and in-flight catering. LCCs took advantage of the low user fees charged by some secondary airports and simpler in-flight service standards as another way of increasing the gap in unit costs between themselves and FSCs. LCCs also operate simpler schedules, where overnight stops at outstations are avoided. This eliminates crew hotel costs and aircraft parking overnight at outstations.

An analysis of fuel, maintenance, crew and aircraft financing costs reveals that aircraft trip costs for FSCs are 20-25% higher than those of LCCs. In the case of LCCs, their costs per seat are up to 50% higher. Taking a 737-800 operation as an example, the aircraft would have about 185 seats in the case of an LCC, but with a FSC it would have 155 seats. When operated on a route length of 700nm and at typical rates of utilisation, which are 3,500FH for the LCC and 2,600FH for the FSC, the aircraft operated by the LCC is about 67% more productive in terms of annual ASMs.

The aircraft operated by an LCC will probably have lower maintenance costs on account of it having less line maintenance at outstations and simpler or non-existent in-flight entertainment.

Even with identical pilot salaries , LCCs have been able to achieve lower total costs of employment. This is mainly due the elimination of costs relating to overnight stops, but there are other savings also. Most LCCs have also achieved higher annual FH productivity from their pilots.

Many LCCs have also crewed their aircraft with a smaller number of flight attendants. In the case of the 737-800 the LCC may use four, compared to six by an FSC.

Some FSCs may be able to close the cost difference with LCCs in each of these four cost categories. The most effective way would be through higher rates of aircraft utilisation. Improved flightcrew productivity might be another way FSCs could close the gap with LCCs. Moreover, some LCCs are increasing seat pitch and reducing seat numbers to attract business passengers.

As described, both LCCs and FSCs are changing their business models which have an impact on non-aircraft related costs. FSCs, including BA, are simplifying or eliminating in-flight catering. Many FSCs have already introduced self-service check-in kiosks and website check-in, reducing their airport passenger handling costs.

In the case of LCCs which used to benefit from low user charges at the secondary airports they utilised, landing and parking fees at secondary airports are now closer to those of major airports.

Revenue management and overall passenger sales processes have also become less distinct between the two categories of airline. As described, FSCs have increased the use of their own websites, simplified their fares, and cut out many costs relating to distribution and sales. LCCs on the other hand are starting to interline with FSCs to attract business passengers, and so will incur costs for GDSs and travel agent commissions as result.

Summary

As with marketing and business strategies, the total costs of LCCs and FSCs are likely to move from two extremes and become less distinct and more blurred.

The FSCs still, nevertheless, have higher costs when factoring in their longer seat pitches and costs of operating premium cabins are considered. They still, therefore, need to attract premium traffic. High multiples of the economy fare are required to do this, but few passengers are currently willing to pay the previous fare. Heavy discounting is required just to break even.

Add to that a further possible drain of premium travellers as other airlines link into travel agents and GDSs, and it is no wonder the FSCs are nervous. Will the FSCs' use of major airports, better schedules, provision of business class cabins and pre-departure lounges, and frequent flyer programmes be enough to make them value-competitive so that they can maintain their fares at a high enough premium? Only time will tell, but one thing is for certain, airlines have some difficult decisions to make. AC