What makes low-cost carriers low-cost?

The major US airlines have found it hard to follow the Southwest model, but Europe's budget carriers are booming

Everybody's doing it — trying to become a profitable low-fare airline that is. Even once-mighty Delta Air Lines has announced the creation of Song, which is due to make its first low-fare revenue flight in April. United, currently in bankruptcy protection under Chapter 11, is looking to form a low cost carrier, which it wants to fully integrate into a hub-and-spoke network "for the first time". But the task of the major US airlines trying to follow Herb Kelleher's Southwest model is daunting, given the failures of such ventures as Continental Lite, US Airways's MetroJet and United's Shuttle, which was scrapped after 11 September.

In Europe the airline heroes of the decade must be Stelios Haji-Ioannou, founder of easyJet, and Ryanair's Michael O'Leary. EasyJet, which carried some 14 million people in 2002, currently operates 64 Boeing 737-300s and -700s, including the fleet of its recently-purchased GO unit. In late 2002, Stelios confounded the doom and gloom in the industry by placing an order for 120 Airbus A319s.

Rivalling Stelios is Michael O'Leary, who expects to carry 15 million passengers in 2003, an increase of 35%, and that's in an exceptionally bad time for the industry as a whole. Ryanair, which recently bought nearly-bust Buzz for a song, currently operates 52 Boeing 737s, but revealed its ambitions for growth early this year by signing for 100 737-800s, in addition to its order last year for 150 of the same type.

Ryanair's fleet will thus grow to 250 aircraft by the year 2010, by when O'Leary expects to carry over 50 million passengers, more than Lufthansa worldwide today. In comparison, Southwest operates 355 737s and serves 58 cities across the USA, so these growth projections are not just fanciful.

EasyJet, which carried some 14 million pax in 2002, raised eyebrows with its order for 120 Airbus A319s

However carriers have to do more than lower their ticket prices, if they are to compete with the low-cost carriers and make a half decent return on investment. On troubles with formerly KLM-owned Buzz, Ryanair notes, "the airline suffers from a number of terminal structural problems, including an inappropriate, mixed fleet, a poor schedule with infrequent services, with fares that are too high to fill its flights". Additionally, according to Ryanair, the airline is heavily overstaffed, carrying less than 3,000 passengers per employee compared to Ryanair's 10,000 passengers per employee. Sounds pretty bad.

Ryanair's all-Boeing fleet is set to grow to 250 aircraft by the year 2010

Taking the axe

Ryanair is taking the axe to Buzz, grounding the fleet for the month of April while its operations are restructured. The fleet is to be reduced from 12 to 8 aircraft, 12 Buzz routes are to be terminated, while another 12 will feature increased frequencies, with fares reduced by 50%.

There will be personnel lay-offs, but staff remaining will be offered increased pay and productivity allowances.

The magic formula of Europe's low-cost carriers (LCCs) has been unveiled in a recent study from the European Cockpit Association (ECA). Yes, the Southwest example has acted as a model for the European LCCs, but there are a number of differences that are notable.

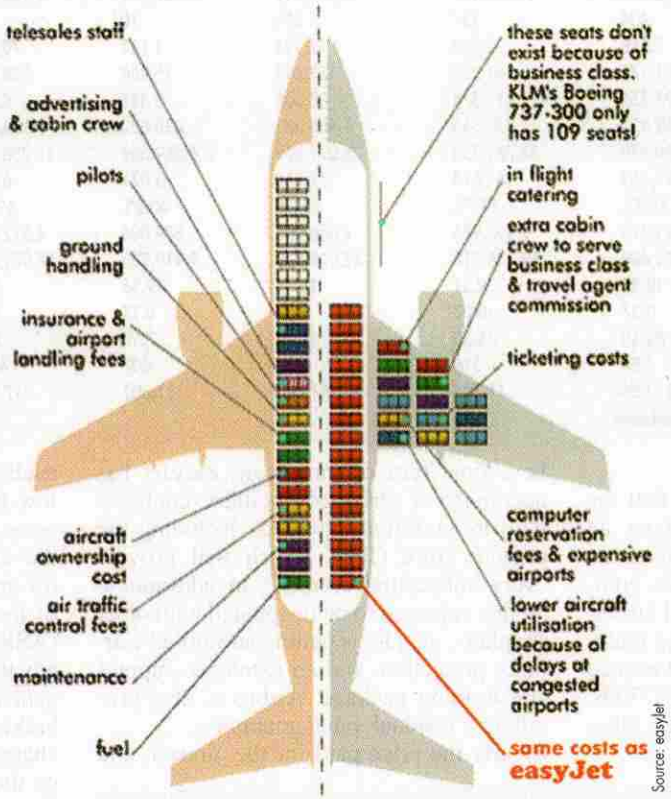
The full service carriers (FSC) are unlikely to be able to match the LCCs in operating cost terms, since they are structured for a different market. This requires global interconnecting services, usually operating from expensive major city hubs, with interlining services, a range of short-haul, medium and long-haul aircraft types, major infrastructure support services, ticketing on a worldwide basis, an integrated route network with feeds into long-haul flights, fancy onboard food and entertainment services, and passenger care and loyalty programmes.

300% growth

In contrast the LCCs serve short-haul point to point destinations, often using secondary, less-congested and less-expensive airports, with no-frills services and a single aircraft type. As a result passengers aiming to connect to an FSC long-haul flight are rarely going to take an LCC carrier, since their connection is not guaranteed, there are no interlining services and they may have to change airports to make the connection. The LCCs are attracting point-to-point, budget-conscious customers who have no need of FSC facilities, and additionally have tapped into a totally new, price sensitive market, people who have never previously been in an aircraft. As a result their business seems set to triple to around 30% of the total European market by the year 2010, while growth at the FSCs is seen as rising by just 5.5% by the same year.

The results of the ECA study (Figure 1), produced from data from a range of respectable sources, shows that the LCC has a cumulative cost advantage of 43%, when all operating cost factors are considered, compared to an FSC.

The difficulties of the FSC carriers pre and post 11 September, combined with the frenzied growth of the LCCs, albeit at a slower pace, have placed the latter in a strong bargaining position in their aircraft acquisition programmes. EasyJet's plan to purchase 120 new aircraft, plus a further 120 options, resulted in a no-holds-barred battle between Boeing and Airbus, where both made exceptional price concessions. Sales campaigns to national FSCs have in the past been more gentlemanly, though Iberia's recent acquisition of long-haul A340-500s, in preference to the 777, is reputed to have been a bloody affair. Even Southwest might not have got the same attention from Boeing.



According to easyJet, this diagram illustrates approximately the number of seats it has to sell to cover each type of expense (left-hand side), while the right-hand side shows how the major airlines – if they offered the same fares as easyJet – would lose money even if they filled every seat

The sheer size of the easyJet order placed the manufacturers under massive pressures at a time when orders are thin on the ground. For Airbus, it was key to break into the low-cost airline market, until now dominated by the 737, while Boeing was fighting to retain a key sales argument of its 737 – "as selected by the low-cost carriers".

LOW-COST CARRIERS ARE SET TO TRIPLE THEIR BUSINESS BY 2010

EasyJet has been more open than is usually customary about its Airbus mega-deal. The bare bones include an agreement "under which Airbus has agreed to supply 120 A319s, which are planned over a five-year period from September 2003, and, in addition, to grant.... the right to acquire up to 120 further A319s for delivery up to 31 December 2012 (provided that delivery slots are available) at the same basic price." Details of financing arrangements are under consideration and negotiation. Following the Go acquisition, 84% of the easyJet fleet is financed or on operating leases. The leasing option is seen as particularly attractive at present due to historically low rates, and the removal of exposure to wildly fluctuating aircraft values.

Seating capacity is a critical element in the operational cost calculation. The A319s offer 156 seats, against the 149 seats installed in the 737-700s presently operated by easyJet, a 4% advantage. EasyJet also has the option to receive the larger A320 and/or A321 with 180 and 220 seats respectively, which could be attractive to cope with growth.

Under the 2001 Boeing contract the list price of the 737-700, with equipment, is quoted at $41.4 million. However easyJet states that it had obtained from Boeing "substantial confidential price and payment terms concessions for its then order of 32 Boeing aircraft."

Under the Airbus contract "the aircraft basic price list of each A319, including the specification change notices and engines, as of January 2001, was approximately $44.2 million. But, easyJet continues, "the company has been granted very substantial price concessions by Airbus and the selected engine manufacturer (CFM).... The company believes it can now purchase the A319 aircraft at a price approximately a third per seat below the price for the 737-700 delivered to it under the Boeing contract."

Assuming Boeing granted a 10% discount on the earlier contract, simple maths indicates the price per seat of the 737-700 was $250,000. Factoring in easyJet's statement, the Airbus price per seat works out at $167,000 (one third less), or multiplied by 156, for the aircraft $26 million, excluding buyer furnished (BFE) equipment, and prior to any allowance for escalation

ANNUAL GROSS INCOME, SHORT-HAUL PILOTS

	AIR FRANCE	BRITISH AIRWAYS	LUFTHANSA	BMI*	RYANAIR	EASYJET	VIRGIN EXPRESS
Long-haul aircraft	97	149	75				
Short-haul aircraft	151	98	205	51	41	24	17
Short-haul-pilots	2,181	1,225	2,695	612	390	250	177
Pilots per short-haul aircraft	14.4	12.5	13.1	12.0	9.5	10.4	10.4
Employees	56,244	62,844	56,500	8,800	1,476	1,632	1,300
Employees per aircraft	227	254	202	173	36	68	76
Pilots per aircraft	14.4	12.5	13.1	12.0	9.5	10.4	10.4
Revenue (€ mil)	12,668	15,040	15,236	1,198	489	578	291
Revenue per employee (€)	225,236	239,319	269,670	136,105	331,054	354,417	223,776
Revenue per pilot (€)	3,536,403	4,871,181	4,139,219	1,957,071	1,252,914	2,317,344	1,645,413
Profit after tax (€ mil)	434	-127	691	10	105	61	-66
Profit per employee (€)	7,718	-2,025	12,228	1,111	70,830	37,600	-50,699
Profit per pilot (€)	121,179	-41,222	187,697	15,969	268,065	245,848	-372,789
RPK (million)	93,355	116,674	88,608	3,837	4,656	4,730	4,016
RPK per employee	1,659,821	1,856,565	1,568,283	436,023	3,154,472	2,898,284	3,089,231
RPK per pilot	26,060,639	37,789,150	24,071,879	6,269,608	11,938,462	18,950,321	22,714,932
ASK (million)	119,562	162,824	117,862	6,071	6,661	7,003	5,749
Load factor	78.1%	71.7%	75.2%	63.2%	69.9%	67.5%	69.9%
ASK per employee	2,125,773	2,590,924	2,086,053	689,886	4,512,873	4,291,054	4,422,308
ASK per pilot	33,376,489	52,736,518	32,019,229	9,919,935	17,079,487	28,056,891	32,516,968
Cost per ASK (€cents)	10.23	9.31	12.34	19.56	5.76	7.38	6.20
Profit per ASK (€cents)	0.37	-0.07	0.59	0.17	1.57	0.88	-1.14
Passengers (mil)	42.40	36.20	41.30	7.10	7.00	5.60	3.82
Passengers per employee	754	576	731	807	4743	3431	2938
Passengers per pilot	11,836	11,725	11,220	11,601	17,949	22,436	21,606

* BMI figures before founding BMI low cost (bmibaby)

Source: EUROPAIRS/ECA

charges.

Not surprisingly, easyJet believes that the A319 as contracted would achieve an approximate 10% improvement over its existing operating cost base, in ATKs, compared to the 737-700. As an added sweetener, Airbus has undertaken that the maintenance cost for the A319s will not exceed the cost of maintenance of the 737-700s, and is providing a technical dispatch reliability guarantee.

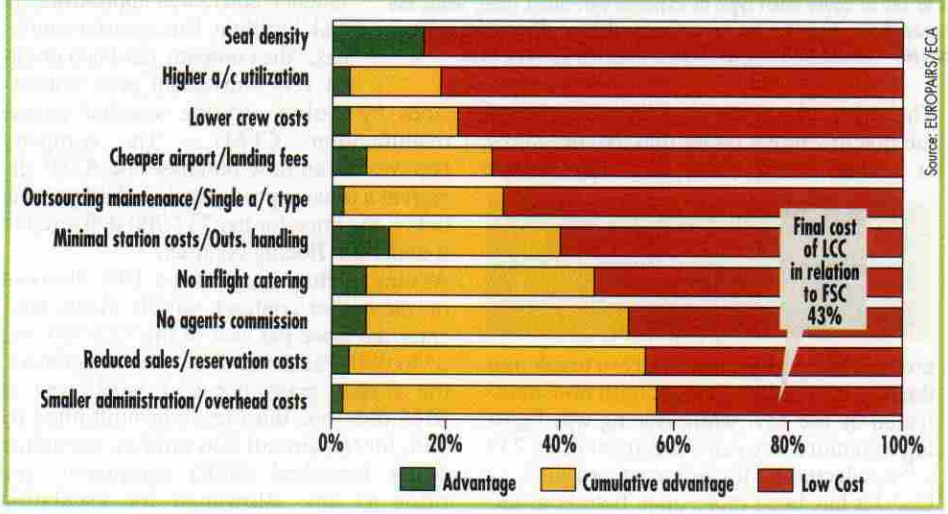
In a final turn of the screw, easyJet has negotiated a series of ancillary contracts with its preferred suppliers, including the engines from CFM, which will provide "very substantial credits." In addition to credits expected to be negotiated with other suppliers, easyJet is getting additional warranty protection, and an extensive support and training package. Airbus is also providing a residual value guarantee.

Clearly the price paid for the aircraft, and each seat, is a key element in setting up the low-fare business model. With a low first price and a residual value guarantee over the expected in-service lifetime, most of the annual fixed costs, and therefore much of the total cost of providing the capacity (ASKs), becomes more predictable. An advanced booking and ticketing software package, guaranteed maintenance costs, locked-in crew contracts, low airport charges and hedged fuel futures is the icing on the cake.

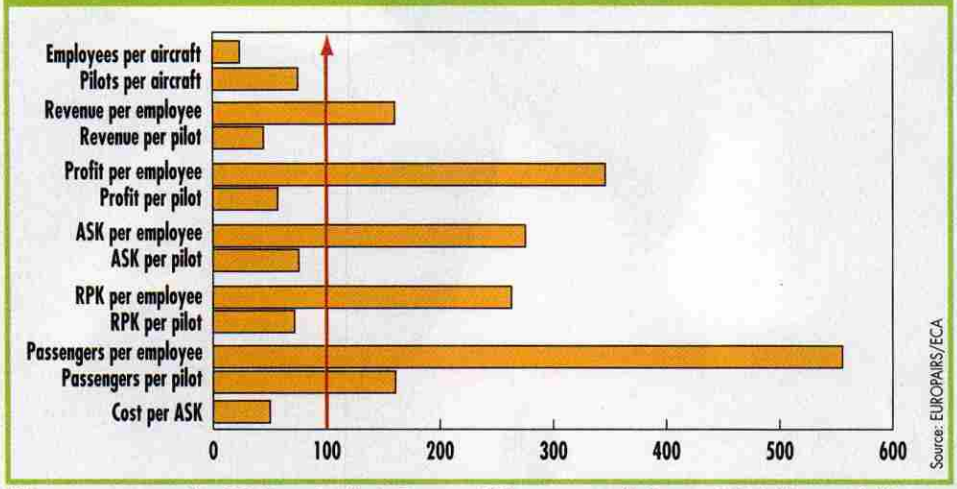
The number of seats available in the aircraft play a key role in shaping the low-fare airline. The obvious rule here is not to waste space, although passengers used to business class may find things a little friendly. In fact most normal-sized passengers will find easyJet's seat pitch quite acceptable for average flights in Europe.

According to the ECA study findings, the high-density aircraft seating configuration in LCC aircraft provides a whopping average 16% cost advantage, compared to the FSC, which typically would offer business or first class facilities in addition to cattle-class. In an example quoted by easyJet, KLM's 737-300s are configured for 109 seats, including business class, compared to easyJet's 130 for the same aircraft, a potential of selling 20% more bums-on-seats (RPKs). According to easyJet, if

LOW-COST CARRIER (LCC) ADVANTAGES V. FULL-COST CARRIER (FCC)



ECONOMIC DATA, LOW-COST CARRIER AS % OF FULL-COST CARRIER



LCCs = average easyJet, GO, Ryanair, Virgin Express. FCCs = average Air France, British Airways, Lufthansa

KLM sold their seats at the same fares as easyJet, they would lose money even if they filled every seat in their aircraft (see diagram). In the USA, Southwest operated 737s at 56% of the costs of Delta, 9% of which came from a configuration of 137 seats in place of 126.

Next on the money-saving stakes are reduced station costs (10% cost advantage), with fewer personnel at check-in and on the line. Many fixed services, such as handling and maintenance, are outsourced. What the LCCs don't advertise is that if flights are cancelled or delayed, they are not going to do much for passengers.

Flying to cheaper airports, with lower landing fees and handling services, contributes some six percent to the bottom line, and not supplying inflight catering, a surprisingly high further six percent.

A single aircraft fleet type is often cited as an advantage for the LCCs since maintenance work is easier and more predictable, and crew costs and flexibility maximised, but the cost advantage actually comes out at a quite low two percent, perhaps an indication of just how competitive the MRO business has become. EasyJet has concluded an outsourcing agreement with Danish-owned FLS Aerospace, under which base maintenance is carried out at a fixed price, plus the cost of materials and time. Component maintenance is charged by the flight hour, while technical services, which include maintenance planning, are charged on a per aircraft basis. A joint venture with FLS Aerospace, labelled easyTech, takes charge of all easyJet maintenance.

Not paying commissions to travel agents adds a healthy six percent to the bottom line, and being a ticketless, web-based operation contributes another three percent to cost savings.

It is often assumed that LCC flight crews are paid peanuts: this is not the case, according to the ECA report, although LCC pilot pay is around 25% lower than FSC pay.

In an FSC crew costs work out at around 10 to 12% of total costs. The LCC cost advantage on the FSCs of just three percent comes from fewer crews needed, due to higher aircraft utilisation (which provides another three percent advantage), a higher crew workload, and fewer overnight stay costs.

The key difference, however, comes with a lower basic pay schedule at the LCCs, compensated by much higher sector pay variable, which typically make up close to 30% of the crew's overall income. This compares with a sector pay figure of under six percent for the FSCs. During periods of lower activity, when crews do less flying, LCC crew costs are lower. Some specialists believe that if sector pay becomes too high a percentage of basic pay, pilots can be encouraged to cut corners in their safety culture, but there is no evidence to support this.

THE KEY DIFFERENCE COMES WITH A LOWER BASIC PAY SCHEDULE

In early 2001 Ryanair's Mike O'Leary negotiated a new five-year contract with his 220 flight crews, resulting in relative restrained increases in basic pay of 15% over the period, but hefty productivity bonuses, which will bring the payscale up to over euro 127,000, plus a further 127,000 in share options.

Air France, BA and LH count between 12 and 14 pilots per aircraft in their short haul fleets, while Ryanair and easyJet have between 9 and 10. The lower number of pilots per aircraft in the LCCs reflects only the higher pilot and aircraft productivity, compared to the FSCs.

Southwest pilots salaries have always been generous, and well above the US average for 737 operators. In fact they work out at about 85% of Delta's 737 salaries. Southwest's profit per employee and per pilot work out at 10 and 25% higher, respectively, than the European LCCs, even though SWA salaries are higher, too.

Outsourcing of services, such as check-in, handling, maintenance and ground activities is a key component of the LCC's business model. This is reflected in the "employees per aircraft" coming out at one quarter that of the FSCs, while passengers carried per employee works out at 555% for the LCCs. EasyJet counts 68 employees per aircraft, against 254 per aircraft in British Airways.

Whopping profit per employee

RPKs generated per employee for the LCCs are 263% higher than the FSC, while profit per employee is a whopping 350% up. However, pilots are employed, not outsourced, which accounts for the relatively lower RPK per pilot compared to RPK per employee figures. Overall, the cost per ASK works out at around half that of the FSC. Revenue per employee approaches double that of the FSCs.

The Southwest model indicates that the US carrier has about 40% more employees per aircraft than the European LCCs, mainly because SWA provides more services inhouse. As a side effect, the revenue per employee is much higher (175%) in Europe. The profit per employee and per pilot is higher in SWA, while the overall cost per ASK is 17.6% higher in the European LCCs.

The LCCs are seen officially by the EU as making an important contribution to the mobility of Europe's citizens, who for decades were subjected to rip-off fares by the former national carriers, combined with restrictive fare conditions – as for example the obligation to stop over a Saturday night to qualify for budget offers. The success of the LCCs has been a major factor in the review of the role of Europe's "majors", with the stock value of easyJet today higher than that of Air France, for example. However even Stelios won't take you much outside Europe, and don't expect interlining or fancy services. ■