

## Module 4 Airline Business Models

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# Full Service Airlines versus Low Cost Carriers

## 1.1 The Full Service Airline (FSA) Business Model

The full service airline business model is that pursued by carriers such as United Airlines, American Airlines, Lufthansa, British Airways, Qantas, Air New Zealand, Cathay Pacific, Singapore Airlines, etc. There are many differences between the business strategies pursued by these carriers, but there are a few key aspects of their business models which they generally share in common.

**Global Network Connectivity.** First, these carriers share the strategy of attempting to offer their customers great connectivity to a global airline system. Since 1945, when the International Air Transport Association (IATA) was formed, these carriers have invested in procedures and systems that allow one carrier (or an agent of the carrier) to sell a product which can take a passenger from origin to ultimate destination, even if it requires one or more transfers to other airlines. This high connectivity product is extremely valuable to a large number of travellers. IATA, individual airlines, support organisations (such as SITA which facilitates airline communications) and governments have built an excellent and relatively seamless network of services. The IATA (and other) interline systems allow an airline (or an agent) in one part of the world to price and sell an airline ticket in another part of the world to a passenger with a long and/or complex itinerary. This first characteristic of FSAs is referred to here as *network connectivity*.

Today a number of airlines have entered into alliance agreements to allow them to provide an even higher level of connectivity. While the IATA system allows any participating carrier to connect to another, the alliances go further by co-ordinating schedules, more tightly integrating pricing so as to allow lower fares for complex itineraries of three or more flight segments, and co-ordinating certain value added services such as lounge access on a global scale.

**Network connectivity is inherently costly.** Providing network connectivity is *inherently* an expensive proposition. Carriers must invest in computer and other systems to enable rapid and seamless carrier-to-carrier communications. An FSA needs a staff that understand the nuances of the interline system and must participate in global forums dealing with issues such as the acceptability of a ticket issued by another carrier and standards on luggage that can be checked-in. Much staff time (hence, a larger staff) is required to deal with irregularities that arise day to day and thereby facilitate the journeys of individual passengers, whether it is baggage which has gone astray somewhere on the passenger's itinerary, or rules for transporting cherished pets. Network connectivity also requires co-ordinated timing of a large number of flights, so as to minimise connection times and maximise the number of cities that can be connected in any given bank of flights. Achieving this high level of connections is inherently costly. Aircraft may need to sit idle at an airport for a period of time in order to depart within a co-ordinated bank of flights. This reduces aircraft utilisation. More gates and labour will be required in order to accommodate the maximum number of connections in a given connection bank of flights.

**High Legacy Costs.** The first general characteristic of FSAs is the network connectivity they provide and the inherently costly nature of providing this service. A second general characteristic of FSAs is that, in

addition to the costs of network connectivity, they have relatively high costs of labour and other inputs needed to provide services. High cost is relative to newly created carriers which are focussed on costs and are able to enter the industry with de novo labour compensation programs, productivity agreements, supplier relationships, and consumer expectations. Some refer to these high factor costs as legacy costs. Generally, they are related to 75 years of collective bargaining and/or to traditionally high service levels offered to passengers.

Consider first the FSAs' high factor costs. FSAs agreed to pay high wages to employees over a span of years. A good example of how this came about was when higher speed aircraft were introduced. In the early days of aviation, for example, it may have required 12 hours of flying time to travel across a continent such as North America or Australia. When faster aircraft were introduced into the fleet, fewer pilot (and other labour) hours were required for the same journey. Generally this reduced flight costs while the airline could charge the same (or higher) air fares for the faster service. Pilots and others bargained for sharing these productivity gains via higher wages, additional benefits or restrictive work rules. Over the decades this resulted in superior wages relative to many other sectors requiring similar skills and thus higher costs for the air carriers. Today, a newly created air carrier will often find it can hire skilled pilots and other labour for a lower wage and benefit package than the legacy (i.e., FSA) carriers, as they have not had to bargain for sharing historical productivity gains.

**Costs of Value Added Services.** Collective bargaining and network connectivity costs are not the only reason why FSAs have relatively high costs. Among many others is the cost of offering a high level of service. For various reasons, FSAs historically offered all passengers a number of value added services, such as in-flight meals, even on short haul flights, free non-alcoholic beverages, lounges for frequent travellers, etc.<sup>1</sup> These services individually added to an FSA's costs, and collectively the cost burden cumulated to a sizeable amount.

**Service Quality: High Frequency, Last Minute Seat Access.** Another dimension of FSAs is that they provided a high level of service quality. While this includes various on the ground and in-flight services, most importantly it includes high service levels in terms of frequency of service and capacity sufficient to provide a high level of last minute availability of seats.

In part, governments were responsible for the high service quality offered by the legacy FSAs. To begin with, in the past most non-U.S. FSAs were government owned and directed.

FSAs generally offer a level of capacity, and manage access to that capacity, so as to provide a high level of last minute access to seats for those travellers with unpredictable travel needs. Providing this higher level of capacity and managing access to it requires multi-hundred million dollar investments by the FSAs.

**FSAs: High service value, but costly to provide.** FSAs offer a product with a high level of service, or a high value. High value in this sense means that the FSA product has additional features (such as high network connectivity and last minute seat availability, etc.) which a number of consumers (but not necessarily all consumers) seek and for which they are willing to pay. Value means *value to the consumer* in this context.

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<sup>1</sup> These amenities can also be traced to the early days of air travel. When transcontinental trips required 12 or more hours, passengers needed services such as meal services, lounges during stopovers, and amenity packages for in-flight use. As aircraft became faster, it was difficult to shed these costs, as passenger expectations had become fixed. As well, because governments regulated air fares, amenities become an important means of product differentiation between FSAs.

While there are many elements to the high level of service offered by FSAs, three dimensions are of paramount importance: i) network extent and connectivity, ii) in-flight and on the ground service levels, and iii) high probability of last minute seat availability.

The FSAs operate medium to large networks, with great connectivity to the global air transport system. That connectivity is achieved via alliances and the IATA interline system. FSAs typically provide redundancy within the service network. This provides the ability to route passengers via alternate gateways and flights if there is a service disruption. To many passengers, especially some types of business travellers, the higher reliability this provides is of great value.

The high connectivity network, the high quality of service and the high seat availability which is made available by FSAs provides value to some consumers but is inherently costly to provide. Network connectivity requires major investments in information systems to track complex itineraries and to communicate with information systems of other network airlines. Investment must be made in infrastructure systems to support the network (such as more advanced baggage systems and catering delivery and information systems). Provision of high in-flight and on-the-ground service levels increases unit costs. High last minute seat availability requires expensive information systems to manage seat availability and may require operating with a larger number of empty seats, on average, than an LCC on the same route.

It should be noted that there is a substantial number of travellers for whom the extensive network and high service levels are not needed. Nevertheless, these passengers are still processed by FSAs through these costly systems.

## **1.2 Emergence of Low Cost Carriers(LCCs)**

While there have been many attempts over the past twenty-five years to establish financially viable LCCs, it has only been in the past two decades that a widely replicable business model for such operations has been achieved. Of the early attempts at low cost operation, that of Southwest Airlines in the U.S., now 42 years old, emerged as one of the few successful models. It has only been in roughly the last two decades that other investors and managers have successfully adopted and implemented this business model to a large number of other markets. Today, air carriers following variants of the Southwest model have appeared in Europe (e.g., Ryanair, EasyJet), Canada (e.g., WestJet), South America (e.g., Brazil's GOL), Australia and New Zealand (e.g., Jetstar), and Asia (e.g., Malaysia's Air Asia), among others.

There were many previous attempts at LCC business models, but these were not successful for a variety of reasons, including government barriers to entry which constrained markets which could be served, airport and other infrastructure capacity constraints, and failure to understand or fully implement key aspects of the business model.<sup>2</sup>

Key enablers of the emergence of viable LCCs have been a) deregulation of markets; b) in some jurisdictions, the availability of airport capacity, in part but not exclusively from the use of uncongested secondary airports in major markets, a successful means of solving barriers to entry from airport congestion as well as offering lower costs;<sup>3</sup> and especially c) better understanding of all the elements of the LCC business model, especially proper capitalisation of the air carrier.

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<sup>2</sup> A few 'new entrant' airlines were absorbed into FSAs. People Express is an example. It was eventually absorbed into Continental Airlines.

<sup>3</sup> It is interesting to note that in Canada, LCC WestJet originally started at Hamilton (YHM), the secondary airport in the greater Toronto region. With the decline in traffic due to 9/11, Air Canada's bankruptcy and SARS, as well as some increase in runway

Regarding the first, Thomas Lawton has stated, "The global economic liberalisation process of the late 1990s was linked inextricably with the emergence of LFAs [low fare airlines] in many countries."<sup>4</sup>

The demonstrated success of a few new LCCs, such as Ryanair and WestJet, to replicate the essential elements of Southwest Airlines business model has induced capital markets, broadly defined, to finance an increasing number of LCCs.<sup>5</sup>

These carriers have been demonstrating sustained growth, with steadily increasing fleet sizes, number of passengers served, revenues, and in many cases profits. For example, it is typical to commence operations with three or so aircraft, and then steadily add capacity. In the early years an LCC may experience growth rates as high as 100%. Growth then typically attenuates to 30-60% at the two to eight year point. Steady additions to capacity on an ever increasing base, lowers the growth rate, although it remains substantial. When Canada's WestJet approached its seventeenth year, it was still growing in the 30-40% range. The LCC with the longest track record is 42 year old Southwest Airlines (U.S.). It grew at an average annual growth rate of 14.7% from 1991 to 2001. This is significantly in excess of the 3.2% growth of the U.S. major network carriers.

As time passes, the high growth rates of LCCs are resulting in an ever increasing share of traffic. In the U.S., where the LCC business model has been pursued successfully by Southwest for over 40 years, it and other LCCs currently provide 24% of U.S. domestic passenger seat capacity. With their traffic growing at double digit rates, their share of passengers carried will continue to increase.<sup>6</sup>

In a paper published in the *Journal of Air Transport Management*, Tretheway (2004) expressed the view that the LCCs will eventually provide 50% or slightly more of the seat capacity in continental markets:<sup>7</sup>

The existing market share of the LCCs in the U.S., the growth of these carriers as manifested in their fleet plans and the redeployment of some of the capacity of the FSNCs [FSAs] to quasi LCC operations suggests that eventually the LCC business model will serve at least 50% of the domestic market. It is not unrealistic to anticipate that the FSNC business model would serve only half of the market or possibly a bit less than this. The above suggests that the FSNCs will be reduced to somewhere in the range of 40-50% of the domestic U.S. market.<sup>8</sup>

It should be noted that these LCC carriers have demonstrated the ability to attract equity and debt capital to finance their expansions. The market capitalisation of Southwest's equity, for example, exceeds that of all U.S. FSAs combined, and did so even prior to the tragic events of September 11, 2001. In Europe, LCC

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capacity at Toronto Lester Pearson International Airport (YYZ), WestJet has transferred some of its Hamilton capacity to YYZ. Some speculate that this is because WestJet believes airport slots will become scarce once again, as Air Canada emerges from bankruptcy, and has decided to lock-up grandfather rights to YYZ slots at desirable times.

<sup>4</sup> T.C. Lawton (2002), *Cleared for Takeoff: Structure and strategy in the low fare airline business*, Ashgate Publishers, p. 184.

<sup>5</sup> Some LCCs are financed by broad shareholdings (e.g., WestJet, Ryanair), some via private investment, such as the original financing of Virgin Blue, and some via an IPO (Virgin Blue again, WestJet).

<sup>6</sup> The 24% share was computed using OAG data for 2003, full year.

<sup>7</sup> Tretheway, M.W. (2004), "Distortions of airline revenues: why the network airline business model is broken," *Journal of Air Transport Management*, Vol. 10 (1), p. 7.

<sup>8</sup> If one uses the 3.2% average annual growth rate of passengers carried by U.S. ATA network air carriers (excluding Southwest) and the 15% annual rate of growth of the LCCs (including Southwest), then in five years, the LCCs will grow from a passenger carried share of 24% to 36% and to 51% after ten years. This does not include any capacity shifted by FSAs to quasi LCC formats. The large number of incremental aircraft on order and option by the LCCs and the low number of aircraft (largely for replacement) on order by the U.S. FSAs, suggests that these simple calculations may be a reasonable indicator of future shares of passengers carried.

Ryanair often trades places with Lufthansa and British Airways in having the highest market capitalisation of any European air carrier; and in Canada, even prior to September 11, 2001, WestJet had a market capitalisation which exceeded Air Canada's by a factor greater than three.

The LCC success has not been confined to leisure or other "discretionary travellers." The LCCs have made major penetrations into the "business" traveller segment. The Business Travel Coalition (U.S.) recently indicated that LCCs are stimulating business travel and act as a discipline on major airlines' pricing:

*"Much of the 4% growth in business travel that BTC projects for 2004 will likely be attributable to low-fare carriers' stimulation of demand as they enter an ever expanding number of markets **and discipline major airlines' pricing.**"<sup>9</sup>*

### 1.3 Why LCCs have a constraining effect on FSA prices

#### **Lower Prices.**

The LCCs have had two major impacts on the FSAs. Both of these have undermined the ability of FSAs to earn revenues to cover their high network, legacy and services costs. First, LCCs have introduced significantly lower prices in the market. This is based on their lower costs – lower because they do not offer the inherently costly degree of network connectivity the FSAs offer, they do not offer the same degree of service amenities, and they do not have legacy factor costs.

LCC prices are typically less than the lowest prices regularly charged by FSAs prior to LCC entry.

Because many of an FSA's former passengers do not need network connectivity for all their journeys or do not need service amenities, these travellers are willing to substitute the LCC product for an FSA trip.

As an LCC offers lower prices, if the FSAs lower their prices in response, even if only for a portion of their seats, their average revenue per passenger (yield) declines.

#### **Undermining traditional FSA price discrimination.**

Second, the LCCs have introduced different pricing schemes which have further undermined the revenue base of FSAs.

When an industry has low marginal costs and either high fixed costs or joint costs, then a means has to be found to offer marginal cost based fares in the market while generating sufficient revenues to cover costs. Price discrimination is used in many industries to achieve this and is regarded in transport industries as an efficient way to recover costs.

Both FSAs and LCCs engage in price discrimination, in the sense that travellers purchasing tickets at different points in time before a flight, or with different restrictions on the use of the ticket, pay different prices.

After considerable market research, FSAs almost uniformly adopted a price discrimination scheme which utilised *restrictions on the trip* to affect the ability to charge different travellers different prices. To "fence off" the high willingness to pay travellers from those willing to travel only at low prices, the FSA price

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<sup>9</sup> "Analysis: restructure more fully, or die: the days of high business airfares are gone forever," Business Travel Coalition, 19 March 2004. Obtained from BTC web site ([www.btcweb.biz](http://www.btcweb.biz)). Emphasis added.

discrimination trip restrictions typically consisted of a required return trip, required Saturday stayover, and/or minimum and maximum stay requirements.<sup>10</sup>

However, any price discrimination scheme is vulnerable to loss of those consumers paying the highest prices either to a competitor with a uniform (non-discriminatory) pricing scheme or to a competitor with a different price discrimination scheme.<sup>11</sup> Because almost all FSAs used the same price discrimination methods, the traditional price discrimination structure allowed the FSA airline industry to support its high cost base for many years.

LCCs also use price discrimination schemes. However, the scheme they have adopted is based largely on the *date of purchase* of the ticket,<sup>12</sup> and *not* on the restrictions on the trip.

This is a simpler price discrimination scheme and does not generate as much revenue as the FSA scheme did. However, the lower revenue is not a problem for LCCs as their costs are lower as well. But because the FSAs' customer base finds the LCC product to be an acceptable substitute, the FSAs have lost an important part of their revenue base. The FSAs could, and in fact some have responded with similar pricing structures, but this may generate less revenue to cover their higher costs.

It is the removal of restrictions on the trip which has fundamentally undermined the ability of FSAs to engage in the degree of price discrimination they had in the past. Most importantly, LCCs have removed the need to purchase a return ticket in order to qualify for a low price, and thereby removed the Saturday stayover and minimum/maximum stay requirements. The offering of low priced *one way* tickets by LCCs is a hallmark of their business model. Southwest, Ryanair, EasyJet, WestJet, Jet Blue, Jetstar and almost all others offer low one way fares and have done so from their inception.

The LCC price discrimination practice has seriously *and irrevocably* undermined the ability of FSAs to command premium prices from those passengers with the highest willingness to pay. In many cases the gap between the previous price charged by an FSA to these passengers and the LCC price is very large. The business traveller unwilling or unable to book a return flight, stay over a Saturday, and book well in advance, previously had no choice but to purchase a high fare, but flexible FSA ticket. Because this traveller has a high willingness to pay, the FSA price discrimination scheme extracted some of their ability to pay, to the FSA's benefit. When an LCC enters the market, this passenger finds that an acceptable air service is available at a significantly lower price from the LCC without the return and Saturday stayover requirement. There may still be a premium charged by the LCC for booking close to the day of the flight, but typically this premium is small relative to the previous FSA price for "last minute" seat availability.

The result is a loss of premium traffic from the FSAs as the business traveller increasingly books on LCCs.

This, in turn, seriously undermines the revenue base of FSAs. This revenue erosion may ultimately threaten the existence of some FSAs if they are not able to shed costs sufficiently. The dilemma is that

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<sup>10</sup> The requirement to purchase a return ticket in order to avail one of a discount air fare is often not directly articulated, but rather implicit in the 'Saturday Stayover' or other minimum trip restrictions.

<sup>11</sup> There is a debate as to whether air carriers price discriminate or offer differentiated products to different consumers. For example, the ability to purchase a seat at the last minute might be viewed as a differentiated product from purchasing seats in advance. The consumer differentiates these products and the costs to an air carrier of the two products can be quite different, with the product offering last minute seat availability requiring provision and/or management of extra capacity. (Even if capacity is managed to ensure seat availability at the last minute, rather than providing excess capacity, there is a higher cost to the carrier. Seats sold well in advance of a flight have certain revenues, while seats held for last minute sales have risk associated with their revenues. There is a cost in the sense of foregoing certain revenues from advanced seat sale in order to have last minute availability.)

<sup>12</sup> They may also charge higher prices for flights at peak periods.

being an FSA is *inherently* more costly due to the costs of network connectivity, last minute seat availability, and other services provided.

This impact is not confined to discretionary travellers, such as tourists or those visiting friends and relatives. The unrestricted low fares offered by LCCs will also influence business travellers, including those who previously flew in the business cabin. For example, in Canada, before WestJet, business travellers generally chose between an unrestricted economy fare (Y, \$1700) and a business class fare (J, \$1950) on a route such as Vancouver-Ottawa. At this difference in fares, many business travellers found the premium for business cabin travel acceptable and often purchased J, due to its higher productivity or comfort. Even when there was an advance purchase non-refundable but otherwise flexible fare available, such as M (\$1200 one way but which allowed changes to date or flight), the difference may have been acceptable to justify business cabin service.

However, when an LCC enters the market and offers a walk up (no advance purchase) but non-refundable one way fare of \$375 on the route, the huge difference in fares makes it difficult for many business travellers to justify purchasing J, or even a flexible Y fare. Prior to the entry of the LCC with very low walk up fares, a business traveller could justify the higher cost of a J fare by the higher productivity of travelling in the business cabin. Consider a consultant who is able to undertake billable work while travelling in the business class cabin, but cannot do so due to the space limitation in the economy cabin.<sup>13</sup> On a 4.5 hour flight, the revenues from a billing rate of only \$60 per hour can justify the cost difference between Y and J, and a rate of \$170 per hour or higher can justify the M to J difference. But with the LCC fare of \$375, a billing rate above \$350 per hour (\$2800 per day) is required to justify the J fare for the business class service. Put differently, at a fare of \$375, the \$350 per hour consultant can justify travelling on the LCC and reading a novel as being more cost effective for the client than paying the J class fare and billing a client for work done on the flight.

### **Impacts on FSAs.**

The entry of an LCC into a market has two impacts on FSA:

First, there is a direct diversion of some of the FSA's previous customers to the LCC.

Second, the inability to sustain the previous FSA price discrimination scheme leads to the introduction of a new pricing scheme more similar to that of the LCCs.

The inability of an FSA to continue to charge high prices to high willingness to pay passengers reduces profits – unless it can achieve cost reductions sufficient to offset the decline in its yields. In much of the world, the FSAs have clearly revealed that often they cannot reduce costs sufficiently, at least in a short time period, to the level of the LCCs. Especially vulnerable when faced with entry of an LCC have been the smaller network carriers in regional markets, such as Canadian, Swissair, Sabena and Ansett, all of which exited their markets.

### **Extension to a broader set of routes.**

This new pricing scheme of an FSA responding to LCC entry is typically applied to a broad range of routes, not merely the ones with direct competition from the LCC.

In part, this response on all routes is due to the threat or high likelihood of LCC entry into other routes. As well, carriers (FSAs and LCCs) have found that customers can and do substitute destinations. This is confirmed by evidence from the U.S. which indicates that the mere presence of LCC Southwest Airlines at

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<sup>13</sup> E.g., many economy cabins have a seat pitch which makes it impossible to open today's typical large screen personal computers.

one of the airports on an FSA route has reduced average fares. Carriers also point out that different pricing schemes on similar routes in a region leads to market confusion and undermines a carrier's brand, hence

The conclusion is that an LCC acts as a strong and enduring competitive constraint on the pricing of an FSA, including for high willingness to pay passengers. An LCC has lower costs as its product is inherently less expensive to provide, it uses a simpler form of price discrimination which generates significantly less revenue, and its impact is felt beyond routes directly served.

## **1.4 New challenges to FSAs from LCC presence in a market**

### **Vulnerability of smaller FSAs.**

Smaller FSAs are especially vulnerable to the challenge of LCC entry which reduces fares and eliminates restrictions. Smaller FSAs will lose revenues due to the new pricing policies in the market. While there is a portion of the market which still values the FSAs network services and service quality, it may favour a larger FSA with a more extensive network. The larger FSA's stronger network, especially if it overlaps the smaller carrier's network, gives it the advantage for those customers for whom network coverage, service redundancy, and service quality are most important.

### **Loss of Traffic Density – moving backward up the unit cost curve.**

Even where an FSA seeks to reduce costs by simplifying in-flight and on the ground service levels, a loss of some traffic to LCCs results in the FSA moving backwards, up its unit cost curve, as it loses traffic density on a route. In this case, it is no longer able to exploit economies of traffic density on a route to the same degree as it had.

Traffic density is an important driver of unit costs.<sup>14</sup> As an FSA loses traffic density on a route or system of routes its unit costs rise. This is why few routes in the world support more than two carriers.

### **FSA financial viability requires re-establishing traffic density.**

Medium to long term financial viability of an FSA subjected to competition from an LCC with one way fares requires that it reduce its costs to compensate for lower yields, as the loss of its former degree of price discrimination offers little prospect for increasing revenue. Unless the carrier can dramatically reduce its costs, which is made difficult by the inherent costs associated with the FSA model, it must re-establish economies of traffic density. This is likely to induce significant restructuring or consolidation in the FSA sector of the industry. This can be achieved by i) exit of a carrier (such as happened when Ansett exited); ii) a much smaller route structure with remaining routes achieving needed traffic density economies (this appears to be happening with the successor of Sabena, which operates only a fraction of the former Sabena's routes, but it does not appear to be happening with the successor of Swissair, which has tried (unsuccessfully) to operate a very large portion of the routes of the former Swissair), or iii) by consolidation of FSAs (as happened when Canadian was merged into Air Canada, and when TWA was merged into American).<sup>15</sup>

### **Simply reducing labour costs will not solve the challenges faced by today's FSAs.**

Cost reductions are not simply a matter of reducing labour costs. Such costs are typically only between 25% and 40% of a network air carrier's cost base. Even a 15% reduction in labour costs (either through lower wages or through productivity enhancements) will translate only into a 4-6% reduction in total unit costs. The source of the cost advantages of LCCs is much more extensive. These carriers have higher fleet utilisation, allowing them to serve a given amount of traffic with fewer aircraft. They typically operate

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<sup>14</sup> See D.W. Caves, L.R. Christensen and M.W. Tretheway (1984).

<sup>15</sup> Note that Southwest had entered TWA's hub at St. Louis prior to the merger.



with only a single aircraft type, enabling significant savings in areas such as maintenance, training, dispatching, and the level of work force required, etc. They are successful at obtaining capital at lower costs (due to their high financial rankings and lower gearings), and operate with dramatically lower distribution costs.

An FSA which obtains lower labour costs from its workforce is only one step on a long path to being better able to compete with an LCC and re-balancing its costs with the lower yields driven into the market by the LCC.

Further, important FSA service elements are inherently costly and cannot be eliminated without fundamentally undermining the nature of the FSA's product.

It should also be noted that the recent attempts to reduce costs by FSAs, especially in North America, are not realising all the hoped for cost savings:

In Canada, the cost savings expected by Air Canada after it negotiated wage and productivity concessions from its organised labour (and achieved cost savings from managerial/analyst labour and from suppliers and other sources) are not being met. "Air Canada has told a court appointed monitor labour concessions agreed to by employees last year will fall short of the CA\$1.1 billion target ..."<sup>16</sup>

In the U.S., where US Airways reorganised under bankruptcy protection, United continues under bankruptcy protection, and American and other FSAs achieved major wage and productivity concessions under threats of bankruptcy, the actual record has been far short of expectations. The following table shows the weak cost savings achieved by U.S. FSAs. Even more interesting is how a number of prosperous U.S. LCCs have been able to achieve cost reductions under programs of continual cost reductions.

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<sup>16</sup> "Concessions by staff fall short: Air Canada," *The National Post*, 26 March 2004, page FP 3.

Table 1: U.S. carrier 2003 cost changes

<b>Carrier</b>	<b>Change in costs per ASK calendar year 2003</b>
<b><i>FSA</i>s</b>	
American	-6.3%
Continental	2.5%
Delta	16%
Northwest	2.7%
United	-8.2%
US Airways	-3.3%
<b><i>LCC</i>s</b>	
Southwest	2.0%
AirTran	-2.7%
ATA	-16.5%
JetBlue	-5.4%
Southwest	2.0%
Source: Airline Business, March 2004, p. 24.	

One reason for the inability of FSAs to achieve hoped for cost savings is due to the loss of economies of traffic density. U.S. FSAs have reduced their factor costs, but as they simultaneously lose traffic, the loss of traffic density economies forces their unit costs back up. For labour (and other) cost savings to have a lasting impact, an FSA must somehow restore its traffic level to previous levels. Further, it must do so while not undermining the characteristics of its product resulting in a loss of even that segment of market which is willing to pay for network connectivity and other FSA value added services.

## Appendix:

### A comparison of the FSA and LCC business models

The table below compares the FSA and LCC business models, indicating that while some elements may appear on the surface to suggest a convergence of the two business models, there are fundamental strategic differences between their strategies. For example, while both may appear to operate hubs, for the FSA, the hub is a strategic asset requiring the deployment of resources to achieve strategic advantage, whereas for the LCCs, hubs are typically a consequence of market sizes.

Element	LCC strategy	FSA strategy	Additional Comments
Costs	Constantly striving to simplify processes and reduce costs. Have achieved continuing cost reductions. Have a corporate culture which supports continual cost reduction.	Collective agreements and network service complexity tend to build in ever more complex processes. Reforms are difficult to achieve. When cost reductions are sought, for many FSAs they tend to be “one off” initiatives, rather than the adoption of continuous improvement management strategies.  Even where an FSA strives for continuous cost reduction, the FSA product is inherently more expensive to provide.	<b><i>A key differentiation between LCCs and FSAs.</i></b>  A few recent cost initiatives by FSAs should not be confused with the LCC business model strategy with its focus on continuous simplification and cost reduction.
Hubs	LCCs have major operations in large cities, where some passengers make connections. However the core focus is the O/D market. “Hubs” (or focus cities as some LCCs refer to them) are largely results of market sizes.	Hubs are strategic assets. Hubs are built and defended.	<b><i>A key differentiation between LCCs and FSAs.</i></b>  The presence of a large number of LCC routes at a given major city should not be confused with an FSA’s strategic hub.
Hub connectivity	Connection opportunities are offered for sale when available, but are not a	Hubs are built to maximise the number of possible connections with	Some FSAs have lengthened acceptable connection times (so

Element	LCC strategy	FSA strategy	Additional Comments
	primary product dimension. 'Acceptable' connections times can be quite long.	shortest possible connection times. This results in the need for extra resources (e.g., more gates, more customer service agents, more aircraft due to longer turnarounds) to accommodate large peak demands.	called rolling hubs) but focus is still on maximising number of connections within the network. Perhaps a vernacular way of describing the comparison is that for a FSA, connections are planned and resourced, whereas for an LCC, "connections happen."
Interline connectivity	Interlining is rare. It requires significant additional costs and systems investments.  Some interline connections are observed, but they tend to be manual interlining from a very small carrier to the LCC, or require the traveller to check-in again with the connecting carrier.  Interlining typically amounts to simple selling of block space by LCCs without any value enhancement by the LCC.	Interline principles are a core concept for FSAs, dating back to the purpose for establishing IATA in the 1940s.  Substantial investments are made in message systems, baggage systems, computer reservation systems, facilitation initiatives such as standardisation of product and rules (such as revenue accounting and allocation between carriers), etc.	<b><i>A key differentiation between LCCs and FSAs.</i></b>  The fact that a few LCCs show interline services with FSAs or regional carriers should not be confused with a strategy of adopting interlinability as one of the key business principles of FSAs.
Code share	Some cases exist, but are relatively rare and not a major focus of the carrier. Due to the strategic focus on O/D traffic, LCCs generally do not seek expanded network scope except for routes they serve themselves.	A key strategic practice which allows the FSA to sell a network of services larger than the route network operated.	
Secondary airports	Some LCCs have used this as an important business	FSAs often serve secondary markets in	The use of secondary airports is no longer a

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	strategy (e.g., Southwest, Ryanair), while others have not.	regions from their hubs, although not to the same extent as the most extreme LCCs.	key differentiation between LCCs and FSAs.
Alliances	Not observed.	A key strategic development in the 1990s to meet consumer demand for service from large network carriers.	<b><i>A key differentiation between LCCs and FSAs.</i></b>
Network scope	Profitable routes are served.	A key strategic dimension. FSAs' strategy depends on serving those passengers for whom network scope is a prime demand element.	<b><i>A key differentiation between LCCs and FSAs.</i></b>
Network revenue impacts	Routes almost uniformly evaluated based on revenues for traffic on the route segment.	Route evaluation will often consider some portion of revenues on connecting segments when assessing the viability of a route.	<b><i>A key differentiation between LCCs and FSAs.</i></b>
Single aircraft type	LCCs typically operate a single aircraft type. Some indication that LCCs may adopt large regional jets, but even so their fleets will be relatively simple.	Because network coverage is a core strategic objective, FSAs attempt to serve as many markets as possible and connect them. This leads to the adoption of multiple aircraft types, with each suited to different route lengths and traffic densities.	The LCC chooses operational simplicity of a single aircraft type (or a small number of types) to keep costs down, and foregoes service on routes for which the chosen aircraft is not economical.  FSA trades off network coverage and service frequency for operating simplicity and cost.
Service	Some LCCs focus only on	By strategic choice, as well as due to legacy	LCCs add services where revenues will

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features	bare bones services. Increasingly LCCs are adding some service enhancements, such as lounges, frequent flyer programs, etc. However, these are provided on a fee for use basis.	strategies, FSAs typically offer a range of value added services.	cover their costs. FSAs provide services as part of the overall service package.  Note that in seat video (being added by a number of LCCs) is a relatively low cost service feature, significantly less expensive than meal service.
Kiosk based check In	A cost reducing strategy	A cost reducing strategy	While some view that automated check-in services are a service enhancement, carriers view them as cost reduction strategies.
Customer Service orientation	Starting with Southwest, most LCCs have successfully developed a strong customer service culture. Service is given cheerfully.	Most FSAs have challenges in the attitudes of their employees toward customer service.	<b><i>A key differentiation between LCCs and FSAs.</i></b>
Product bundling	A key strategy is to unbundle airline services to passengers. The LCC offers a core product at a low price. Additional services, such as lounge access, meals and beverages are typically sold for premiums. Where frequent flyer rewards are offered, a higher fare typically must be booked. LCCs do not bundle any inter-airline connectivity services	FSAs offer bundled air services as a matter of strategic choice and legacy. This will include features such as network connectivity and convenience, lounge access at no charge for frequent travellers, on board meals on medium and long haul flights, and frequent flyer rewards.	<b><i>A key differentiation between LCCs and FSAs.</i></b>