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Budget Beaters

Low-cost carriers have always been pioneers in keeping costs low; Now the key is maintaining them

By Raphael Bejar, CEO, Airsavings

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To the general public, the term 'low-cost carrier' is synonymous with 'low-fare airline'. For low-cost carriers, this is often good, desirable and well-aligned with their operating strategy; competing on the basis of price has been a consistent hallmark of the LCC revolution. But while conventional wisdom interprets the low-cost carrier label in terms of revenue (low fare prices, fee-for-service models), the actual genesis of the term comes from the expense side of the ledger. The phrase "low-cost carrier" refers in fact to the minimization of operating costs, and while passengers may not be privy to the actual steps implemented to keep these costs low, it is the fact that they are kept low that enables the airline to sell its seats at a competitive price.

For the flying public, this is not an important distinction. For the operators of low cost airlines however, it is increasingly important to effectively manage costs, and retain their inherent competitive advantage over legacy airlines.

In other words, it's imperative to keep the 'low cost' in low-cost carrier.

Because fuel is a significant fixed cost for all airlines, and because the media and the public are highly attuned to fluctuations in the price of crude oil (and thus gasoline, heating fuel, etc.), how airlines manage their fuel costs tends to be the most visible method of cost control -hence the hubbub over fuel hedging in 2008 and early 2009. But airline expenses are numerous and managing them all is of foremost concern for those low-cost carriers that base their operating margin on the effective control of costs.

For the sake of argument, though, let's begin with fuel.

Fuel Costs

The cost of oil has always been a central consideration for transit and transport industries in general, particularly for the airline industry, which has historically needed greater quantities of fuel compared to other methods of conveyance. But given the volatility in the global fuel market (driven, largely, by the financial crisis of 2008 and the ensuing global recession) there is renewed interest in fuel cost mitigation, the reduction of consumption and the overall scope and trend of the oil futures market.

In no industry is this sense more acute than the airline industry, and for good reason. In 2008, for instance, every dollar increase per barrel drove an additional $464M in fuel expenses for U.S. passenger and cargo airlines; every penny increase per gallon drove $195M in annual expenses. Historically, fuel expenses have ranged from 10 percent to 15 percent of U.S. passenger airline operating costs, but averaged more than 35 percent in the third quarter of 2008.

These are large percentages, but they are by no means new discoveries. The whole industry, particularly LCCs, are well -versed in the meteoric nature of oil prices, and are aware of the difficulties inherent to operating in an environment of unprecedented fixed (read: fuel) costs coupled with intense downward pressure on prices and increasingly elastic demand. Airlines have typically employed a handful of methods to help offset the volatility of oil prices, including hedging, term contracts, spot market speculation and purchasing alliances, all of which have had varying degrees of success in the current climate of unbridled price increase.

The technique that has garnered the most attention is hedging, which (very simply) is when an airline buys a fuel futures contract at a current price for delivery in a specified period, often more than a year in advance. Hedging works best in a market with steadily rising prices and limited volatility, though in the current market it has worked for those airlines that have committed substantial resources to maintaining what is, in effect, a commodities brokerage in addition to their primary air transit operations.

Most airlines engage in term contracting with individual fuel suppliers, foregoing the need to 'play' the speculative oil markets, but also foregoing the long-term cost savings enjoyed by Southwest and other hedge-happy airlines in favor of shorter-term, negotiable contracts (also, it should be noted, insuring against a sudden drop in fuel prices, as Southwest in particular, learned in early 2009). Term contracting is more flexible than hedging, while still providing a measure of security against price volatility, and therefore is often preferred.

Of course, both of the above methods are employed by larger, established airlines (even Southwest, with its low-cost carrier cachet and provenance, is a giant among LCCs and in the US marketplace).

Emerging low cost and midsized airlines have different concerns when it comes to purchasing fuel, namely obtaining a price comparable to that paid by legacies and other large airlines. All things being equal (excepting hedging and spot market speculation), the large legacy airlines have the advantage of economies of scale over their smaller or regional competitors. Airlines like Southwest and American have far more purchasing and negotiating power with fuel suppliers than do lines like Spirit or JetBlue, simply because they need to buy more at any given time. The only avenue LCCs and midsized players have to combat this competitive advantage is the formation of purchasing alliances.

Group Purchasing

Alliances and other group purchasing organizations allow several airlines to pool their individual needs to purchase in larger quantities, including recurrent items like fuel and fuel term contracts. While there is no prognostication involved, no long-term betting or market speculation, group purchasing is nonetheless the most accessible and effective way for low cost and midsized carriers to level the purchasing playing field with the majors. Several organizations facilitate the development and establishment of these alliances, and allow many of the LCCs that have reshaped the airline industry in the past decade to maintain their successful business model and compete with established carriers worldwide.

For a market like Europe, which has enjoyed significant growth in LCC presence in the past fifteen years, carving out a competitive advantage is imperative. Struggling against legacy carriers with international purchasing departments and economies of scale will invariably lead to unfavorable operating margins. Similarly, competing with another LCC that engages in group buying practices or contracts a group buying services firm to create purchasing alliances will likewise lead to insolvency. The solution, then, on the expense side of the ledger, is to devise a strategy that incorporates some sort of collective purchasing. Other industries, notably the lodging industry, have practiced this for years, lowering their supply costs in like markets to facilitate competitive advantage.

The price of oil, in the very long term, is likely to continue on an upward trajectory. As a finite, non-renewable resource, the supply of oil will only become more constricted as the years pass. This will hold true despite the year-to year (or month-to-month) fluctuations in the commodities markets. The only real long-term solution to outlandish fuel prices, then, is a reduction of demand. Technology, including that affecting the airline industry, is moving in that direction.

But the cost of oil and fuel, whether managed by hedging or purchasing alliances, are not the only expenses an airline incurs.

Other Costs

Low-cost carriers have always been in the forefront when it comes to managing other costs well, in addition to fuel. Labor, often the largest fixed cost (excepting fuel), is aggressively managed in both the skilled and unskilled labor pools. Low-cost carriers tend to employ younger pilots and engineers, and minimize the influence of unions on their operations. This performs a vital function for the industry at large, by providing opportunities for skilled personnel trapped in the sluggish hierarchies of legacy airlines as well as entry-level skilled positions. LCCs can also take steps to reduce redundancies that necessitate quantities of unskilled workers. Online ticketing and reservations, which are the revenue pipelines for LCCs (and other airlines) do not need full reservation staffs to run them, and so LCCs encourage the use of these systems. Self check-in and airport kiosks are also labor-saving LCC innovations.

In fact, LCCs often create revenue opportunities at labor-heavy consumer touchpoints. Though the rise in checked bag fees is most often attributed to the rise in fuel costs (and thus the rise in the cost of transporting any given amount of freight, including a checked bag), there is a significant labor cost incurred by the airline for the baggage handling process. Not only does a checked bag fee mitigate that cost, it also reduces the volume of baggage (in theory) that personnel must handle, allowing for further reduced labor costs.

This same principle- creating a revenue opportunity from a high-cost service- translates to the airport and cabin as well. Airport lounges, for example, can be monetized in the form of airport lounge passes or upgrades. Likewise with in-cabin refreshment and entertainment; what was once a significant expense provided to passengers for free is now a new sales option, with the added benefit of not having to keep the inventory onboard to satisfy every passenger.

For low-cost airlines, which have ceded some of this innovative edge to cost-cutting legacies, the need to create more revenue opportunities from high-cost obligations is as acute as it's ever been. Airlines would do well to follow this basic principle as a basis for new cost conservation measures, as well as or revenue generation strategies.

Conclusion

Though legacy carriers have come to follow LCCs from an ancillary revenue generation standpoint, they still lag on cost control, which can explain some of the appeal of LCCs - particularly in the markets mentioned above. LCCs still put greater emphasis on ancillary revenues than legacy carriers, as they represent a larger percentage of their overall revenues. Their most distinguishing characteristic, however, has become fixed cost mitigation. In an environment that is likely to feature slack demand for at least the first half of 2010, LCCs will be in a better financial position in terms of expenses than legacies.

In terms of fixed costs, the advantage might seem to go to legacy airlines, with their economies of scale and global purchasing presence. But low-cost carriers have demonstrated their proficiency at both fuel hedging and in engaging in purchasing alliances to minimize legacies' buying advantage. LCCs have always done better at controlling costs than their legacy counterparts, and even as legacies adopt a more LCC-like operating strategy in 2010, the globe's low-cost operators will likely still maintain their edge in this area.

This is not to say that cost mitigation won't be apriority for all airlines. It will be incumbent on every global and regional carrier in 2010 to at least try and emulate the low-cost model, as demand levels will necessitate controlled expenses.

So to maintain their competitive edge in this area, LCCs will have to work hard at keeping the 'low cost' in low-cost carrier.

About Raphael Bejar

Raphael Bejar is CEO of Airsavings, a company that specializes in facilitating the two fundamental operational imperatives of the airline industry: cost reduction and revenue generation. By assisting airlines in unbundling their core services and providing a rapid, cost effective platform on which to offer ancillary services, Airsavings helps carriers to swiftly and easily develop alternative revenue streams. And by employing one of Europe's most successful group buying systems, Airsavings helps member airlines obtain competitive pricing on critical goods and services. As founder and chief executive of a company that focuses on the critical operational aspects of low cost and mid-sized carriers around the globe, and with his 18 years of experience in airline finance with European giants Credit Foncier and Jet Finance, Mr. Bejar is uniquely positioned to comment on issues affecting the airline industry. Mr Bejar holds a degree in aeronautical engineering from the ESTACA in Paris and a postgraduate degree in Banking and Finance from Paris University. He is 45.

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