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The long-haul low-cost carrier: A unique business model

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A B S T R A C T

While many industries reach a point of maturation, the airline industry is evolving to incorporate flexible strategies for business models that adapt to the changing economic environment. New business opportunities have emerged as a result of a variety of internal and external forces. This paper discusses opportunities for long-haul low-cost airlines by looking at the evolution of the model and defining three types of new business models.

1. Introduction

The airline industry is a risky industry to invest in, statistically second only to the hospitality industry, and yet investors are continuously attracted to it regardless of its economic state. One of the main reasons it is attractive to investors is that it is one of a few industries that can provide a large payback if things work out well. It is helpful to have a full understanding of trends in the industry to comprehend its current position. It is also important to realize that there have been trend breaks and that new trends have emerged to present fresh challenges to the industry.

The airline industry is often unstable and unpredictable, forcing airlines to restructure and create flexible strategies that can respond as external operating environment changes. New airlines have an advantage over existing carriers in terms of implementing such strategies because they are devoid of legacy indebtedness or an out-of-date business model.

2. The global airline industry

The global industry operates in periods of survival, adaptation, recovery and innovation, resulting in the need for flexible business strategies more than ever. Following the terrorist attacks on the US on September 11th, 2001, the airline industry was in survival mode. These unfortunate events have pushed the airline industry over the edge and resulted in a record number of bankruptcies, mergers and acquisitions. The global aviation industry suffered financially and still continues to recover. In 2002, airlines in the US lost $10 billion (Wensveen, 2007a).

In the 2002–2003 period, airlines were forced to adapt to the changing environment. Airlines that survived the immediate shake up sought ways to adapt in the new industry. This period saw a focus on cost -reduction as airlines reduced capacity, cut many in-flight amenities, downsized management, outsourced non-critical operations and parked older aircraft. From 2003 to 2005, airlines entered a period of recovery. Much of the opportunities for cost savings were exhausted and airlines returned to focusing on revenue maximization. During this period, revenue and yields returned to pre-September 11th levels and US airlines posted profits (Fig. 1).

In the 2005-current period, which is expected to last until another cataclysmic event occurs, airlines have continued to innovate and rethink the way they do business. It can be argued that the recent oil crisis has been another cataclysmic event and has forced many airlines into survival mode. This is evidenced by the numerous failures, acquisitions and mergers. Both legacy and low-cost carriers have differentiated their business models to capitalize on emerging market trends. Air Canada made a drastic change towards unbundling the airline product and offered customers the choice to personalize its product. Though US carriers have made similar changes to their business models, those changes have not been as drastic as those made by Air Canada. Aer Lingus evolved from a typical legacy carrier with no unique competitive advantage to a low-cost network carrier with a focus on long-haul routes. Aer Lingus took large measures to make their cost structure competitive with those of the short-haul low-cost carriers (LCCs) by moving to a modern, all Airbus fleet. The airline has further attempted to change employee work rules and generate ancillary revenue by unbundling its product. Much of the innovation during this period came from the many low-cost, long-haul start-ups.

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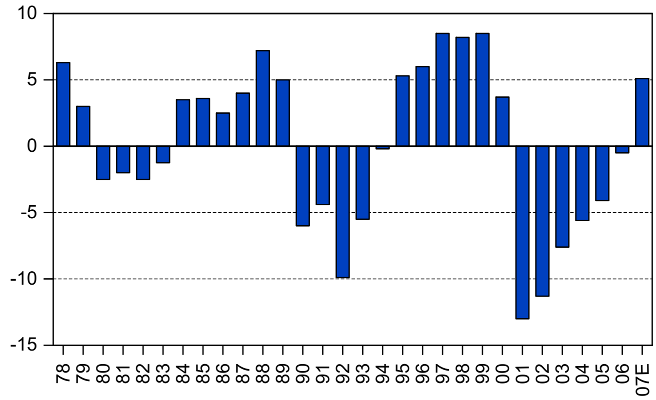

Fig. 1. Net profit/loss for world airlines 1978–2007 Morrell (2008).

3. Evolution of the long-haul low-cost model

Airline strategy, once politically motivated, is now driven in large part by consumer demand in liberalized and deregulated markets (Leick, 2008). Airline business models are adapting to changing passenger lifestyles and behaviors (Taneja, 2005). Technology has increased the availability of information and has shifted leverage into consumers' hands, which has resulted in less homogeneous customer segments. It has also provided suppliers in all industries with the ability to meet the needs of individual consumers more efficiently and cost effectively. As a result, airline passengers expect a more 'logical' product, while innovative technologies and ideas have provided space for airline business models to evolve.

Shifting consumer behaviors have resulted in network carriers steadily loosing market share to a variety of more innovative business models. Low-cost airlines have existed in some form even before the liberalization of air transport markets. Southwest Airlines, established in the early 1970s, is considered the grandfather of the model. Even before Southwest Airlines, commuter carriers often operated at costs below those of the national carriers. It was not until carriers such as Pacific Southwest Airlines (PSA) began offering fares less than those of their competitors that the low-cost, low-fare model emerged. JetBlue later took the low-cost model to a new level by adding amenities superior to those of network carriers. Their leather seats and live satellite televisions in each seat became a trademark of the airline. As of 2005, LCCs in the US and UK had grown to control 30 and 40% of the market capacity respectively (Taneja, 2005).

Conversely, the emerging trend of corporate, high-yield business traffic migrating to fractional ownership and corporate jet operations such as NetJets and ExpressJet threatens the airlines' premium market. Very Light Jets (VLJs) have recently emerged on the scene and threaten to cut into the high-yield business market even further. High yielding first and business customers have always been the cornerstone of network carriers. However, these customers no longer provide the revenue stream they once used to. Premium cabins have largely become a loyalty reward and have all but disappeared outside of long-haul routes where they remain a high-yielding product. The large global carriers have shifted much of their capacity out of domestic markets to capitalize on the more profitable long-haul routes and invested large sums of money to make their premium cabins competitive.

Out of these changes in the global air transport industry evolved the low-cost, long-haul model. Entrepreneurs took to the skies determined to cash in on the untapped demand for low-fare, high-value air travel in the international long-haul market. Several different models emerged but all of them encountered similar challenges.

3.1. Definition of "low-cost"

The airline industry has become accustomed to the term "low-cost carrier" otherwise known as LCC. Unfortunately, aside from the various perceptions or stereotypes associated with the term low-cost, few understand the true meaning that often results in a misuse of the definition. Equally curious is the way in which industry experts use multiple definitions for what essentially means the same thing. Examples include:

- Low-Cost, No Frills Carrier (LCNF)
- Low-Fare, High-Value Carrier (LFHV)
- Less Frills Carrier
- Value Carrier
- New Generation Carrier

We take the view that there is no such thing as a low-cost carrier. Airlines, regardless of their business model or geographic location, essentially have the same root costs (i.e., fuel, labor, maintenance). Granted, some airlines have major advantages over others in terms of these root costs, but the cost structures for all airlines are essentially the same. This is evidenced by the equal number of difficulties that both legacy and LCCs face in the current market environment. With that said, the author does use the term LCC in every day practice but the reader should have a full understanding that such terminology is used very loosely.

3.2. Long-haul vs. short-haul flying

The differences between the low-cost, long-haul carrier and the low-cost, short-haul carriers are inherently different, particularly when it comes to crew requirements, security requirements, airport facilities, turn around times, route authorities, extended-range twin-engine operational performance standards (ETOPS), training differences, distribution challenges and route density. Short-haul LCCs derive their competitive advantage from operational efficiencies. The opportunity for carrying over this competitive advantage into long-haul operations is rather limited. Instead, long-haul, low-cost carriers aim to achieve a competitive advantage by optimizing yields from the available aircraft capacity. Legacy carriers use highly discounted economy seats to fill the excess space left after premium demand is met. Revenue from premium cabins subsidizes the cost of the economy cabin. Long-haul, low-cost carriers maximize all available space with profitable, premium seating at a rationalized price. To be successful, a new entrant must seek real advantage in all of these factors and find markets where lower fares than the competition can be profitable.

The concept of low-cost, long-haul flying is not new to the industry but it is not an established sector as of yet. Skytrain, started by Freddie Laker in 1977, operated between London and New York and offered return airfares substantially lower than its legacy competitors. Unfortunately, Skytrain was out-priced by the competition. The air transport market has changed dramatically in recent years and the low-cost phenomenon has now become widely accepted. The continuing deregulation of the industry and the restructuring of multiple bilateral agreements between states in the rest of the world have increased the number of opportunities to start new operations. To survive in the long-haul market, low-cost airlines have to avoid the common pitfalls in airline business planning.