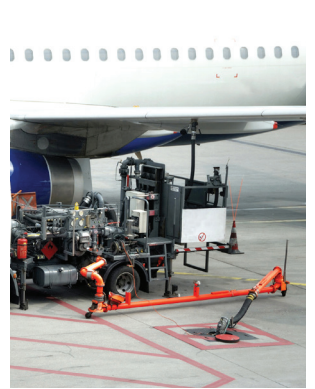


Travel, Transport & Logistics



A short life in long haul for low-cost carriers

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A short life in long haul for low-cost carriers

Following the success of low-cost carriers (LCCs) on short-haul routes, a few airlines have begun to apply the low-cost model to long-haul, intercontinental routes. Long-haul routes are highly attractive; in the United States they account for about 40 percent of mainline operating revenues and over 90 percent of operating profits (Exhibit 1). We believe, however, that there are limitations to the LCC model in the long-haul market.

LCCs that succeeded in short haul enjoyed structural, hard-to-match cost advantages; markets with significant latent demand; and a unique value proposition that appealed to and was perhaps even preferred by a wide range of customers. The combination of these factors has enabled LCCs to continuously underprice mainline airlines, limit retaliation, and over time build a loyal customer base that will not switch carriers when and if mainlines choose to match prices. However, this model is difficult to replicate on long-haul routes. And while there is significant opportunity for a lower-priced, lower-cost model in long haul, we believe that mainlines can and ought to capture it. And if they act quickly, there will be no need for—and indeed no room for—new entrants in the long-haul market.

Not so low cost

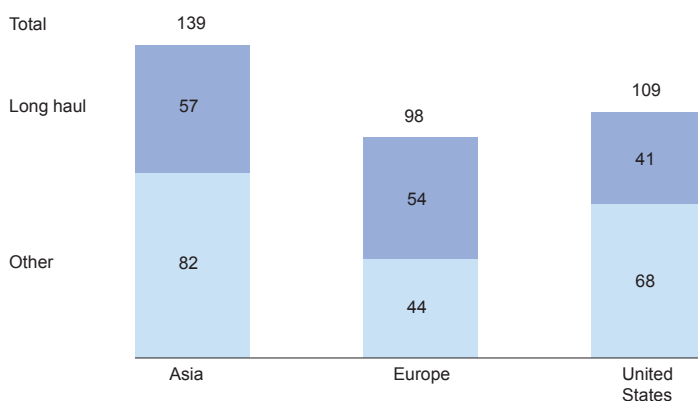
In short haul, LCCs combine lower input costs with higher productivity to achieve a 25 to 50 percent cost advantage over their mainline rivals. However, the operating economics associated with long-haul flights are different. A simple cost model shows that in long haul, the 26 percent cost differential between LCCs and mainlines is reduced to a slight 13 percent

when seat density is removed from the equation (Exhibit 2). Put another way, half of the potential unit-cost advantage for long-haul LCCs is from higher seat count, produced by shrinking the premium cabins and making the economy sections denser. The other half is from input costs, which are less flexible in long haul (Exhibit 3). For instance, on long-haul flights, fuel's share of direct operating costs grows from 30 to 50 percent.

While an LCC applying all strategic levers could enjoy a considerable cost advantage, mainlines are not at a disadvantage here for three reasons. First, some mainlines are beating LCCs at their own game by optimizing economy-class floor space with high-density seating configurations. Air France's Boeing 777 fleet, for example, features ten-abreast seating in economy class. Second, mainlines can vary their seat configurations to reflect market conditions and demand. For example, Air France and British Airways are flying 777s with higher-density seating configurations to leisure destinations such as the Caribbean. Third, premium cabins and belly cargo allow mainlines to enhance overall flight revenues before taking on economy passengers. Indeed, premium traffic may account for only around 10 to 20 percent of passengers, yet it can represent up to 50 percent of revenues in long haul. Cargo often contributes an additional 5 to 20 percent. These revenues can offset economy-class costs and give mainlines the opportunity to further reduce economy fares. Last, aboard a long-haul flight, there are limits to the LCC value proposition. In short haul, LCCs compensate for a lack of amenities with friendly and efficient service. However, food and beverage, in-flight entertainment, and passenger comfort play a bigger role in long haul.

Exhibit 1 Long haul accounts for a significant portion of mainline revenues.

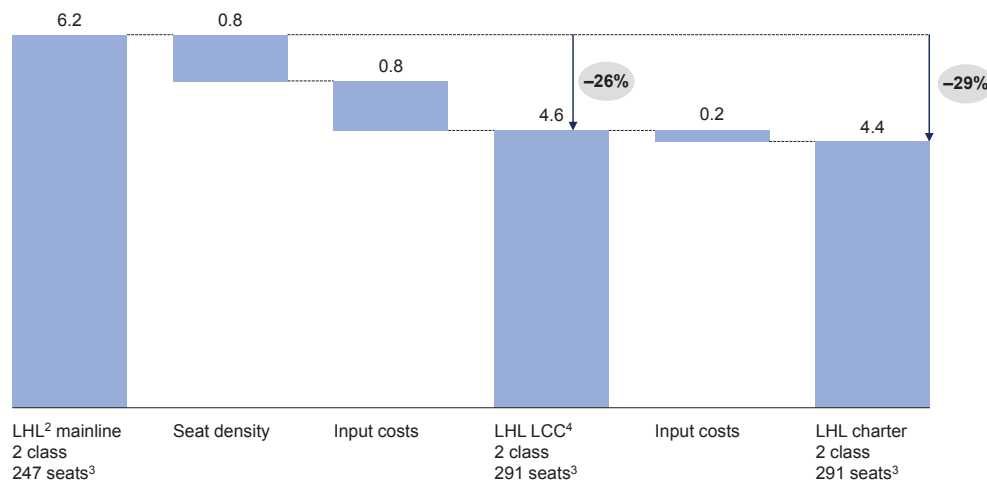
Mainline revenues by route, 2011
\$ billion



Source: Annual reports; US Department of Transportation, Form 41

Exhibit 2 Seat density accounts for a significant portion of the low-cost-carrier advantage.

CASK¹ for Boeing 787-8 on 8-hour flight
cents



1 Cost per available seat kilometer.
2 Long-haul.
3 Seat counts based on announced configurations by carriers fitting the respective archetype.
4 Low-cost carrier.

Limits to latent demand

LCCs' ability to drive demand by lowering prices has contributed significantly to their success in short haul; cheap flights inspire people to fly to neighboring cities for the weekend or the day. However, our analysis suggests that there may be limitations to this approach in long haul.

First, total ticket costs are higher in long haul, and cross-elasticity of demand (that is, the ability to buy some other substantial item that a household might need or want) plays a role. Relatively high "all in" ticket prices for a far-off destination face stiff competition from other discretionary leisure spending. Indeed, in long haul, the total price, with fuel surcharges and various taxes, is much higher than in short haul (Exhibit 4). Both encroach on the disposable income that would otherwise be allocated for spending on the entire trip and raise the budget required to levels where cross-elasticity with other household expenditures is likely to lead would-be travelers to abandon trips altogether. At the same time, cross-elasticity with other modes of transport, such as rail and bus, is limited. This reduces the opportunity to poach travelers from other modes.

Second, low fares are already available in most markets. Sixth-freedom¹ options are priced significantly lower than their point-to-point alternatives and widely available. Also, in many leisure markets, LCCs already exist in different forms: holiday/charter carriers serving price-sensitive travelers on leisure routes (for example, Corsair and Thomson) have a particularly strong market influence in Europe; scheduled carriers catering to the visiting-friends-and-relatives passenger segment are especially prevalent on routes with strong ethnic ties, such as the Iberian Peninsula and Latin America.

Opportunity for lower cost: Advantage, mainline

Over the last decade, LCCs have entered every major intercontinental market. On the longest flows, such as the North Atlantic, Europe to Asia, and transpacific, an LCC has yet to survive a full economic cycle. However, LCCs will continue to pursue long haul and compete with mainlines, despite the significant business and profitability constraints. Given the aircraft types that are currently in service, we

¹ The sixth freedom of the air is defined as the right of an airline to carry passengers and/or cargo from one country to another via the airline's country of operations (for example, Emirates from London to Bangkok via Dubai).

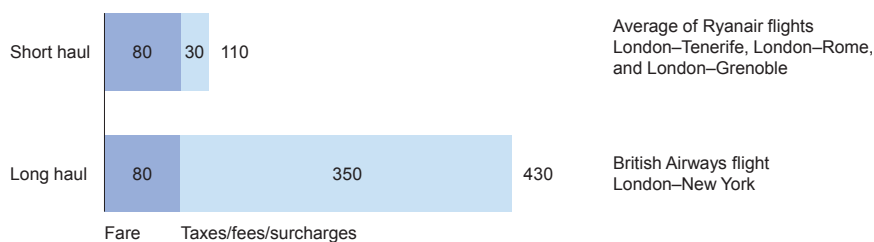
Exhibit 3 A look at the operating economics of the 787-8 highlights cost differences.

Line item	Mainline		Low-cost carrier		Charter		Unit
	\$/BH ²	Input cost	\$/BH	Input cost	\$/BH	Input cost	
Aircraft/insurance	2,467	879,000 12	2,467	879,000 12	2,467	879,000 12	\$/month BH/day
Fuel	4,386	1,700 2.5	4,386	1,700 2.5	4,386	1,700 2.5	Gallons/BH \$/gallon
Maintenance	855	855	855	855	855	855	\$/BH
Cockpit	544	300,000 60% 10,000 75	411	300,000 20% 10,000 75	411	300,000 20% 10,000 75	Salary/year/crew, \$ Benefit load, % Training cost/year/crew, \$ BH/month/crew
Cabin crew	390	32,000 40% 8 2,000 80	310	32,000 10% 8 2,000 80	310	32,000 10% 8 2,000 80	Salary/flight attendant/year, \$ Benefit load, % Cabin crew/aircraft Training cost/year/crew, \$ BH/month/crew
Hotel accommodation	167	200	125	150	125	150	\$/crew member
Airport/navigation	831	2,000 2,530 10	661	1,500 2,530 5	679	1,500 2,530 5	\$/turn, aircraft \$/leg, landing and navigation \$/passengers, handling
On board	524	20	310	10	173	5	\$/passengers
Sales and distribution	918	35	310	10	104	3	\$/passengers
General and administrative	315	12	155	5	69	2	\$/passengers
Total cost \$/BH	11,396		9,989		9,579		
CASK³	6.2		4.6		4.4		

1 Seat counts based on announced configurations by carriers fitting the respective archetype.
 2 Block hour.
 3 Cost per available seat kilometer.
 Source: *Aircraft Commerce*; annual reports; Boeing; US Department of Transportation, Form 41; International Air Transport Association; International Civil Aviation Organization; pprune.org; McKinsey analysis

Exhibit 4 Taxes, fees, and surcharges are considerably higher on long-haul routes.

Cost of typical return ticket
 £



Note: Web search conducted on November 7, 2012, for a 7-day return trip in February 2013.
 Source: britishairways.com; ryanair.com

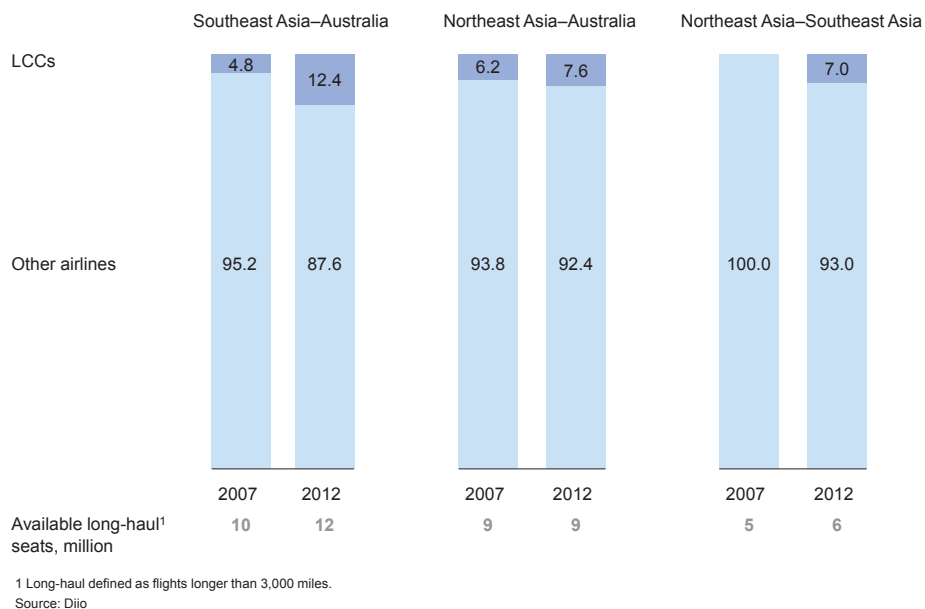
believe LCCs will struggle to succeed on long-haul routes in the 8- to 12-hour range. We expect them to focus their efforts on routes in the 4- to 7-hour range. However, some LCCs are already succeeding on long-haul routes within Asia (Exhibit 5). AirAsia X and Jetstar Airways, for example, are taking share by entering new markets first and assuming control of existing and emerging leisure routes.

Mainlines cannot afford to stand idle. Low-cost operators will continue to enter the long-haul market, at considerable cost to all parties. While mainlines have several natural advantages they can use to stave off LCCs—including

knowledge of the low-cost model, attractive frequent-flyer programs, and the resources to withstand short-term losses—it may be time to rethink the traditional long-haul business model. First, density matters and high-density seating configurations are crucial to lowering costs. Second, by unbundling the traditional long-haul product, mainlines can offer passengers more customized and attractive fares. Third, a number of mainlines actively track fares and take corrective action to discourage new point-to-point entrants when necessary. Mainlines may consider taking the next step and strategically revisiting the proportion of connecting and point-to-point traffic they carry.

Exhibit 5 Low-cost carriers are gaining market share in Asia.

Top 3 flows for LCCs in Asia
% market share



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