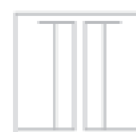
LOW COST CARRIERS'

outlook

amidst current oil spikes



Are low cost carriers set to cruise on *blue skies* ahead?

Recent developments in the Middle East have resulted quite logically in yet another flurry of oil spikes, as well as another round of fuel surcharges to the detriment of the air tra-veler. Despite the typical chorus of denials by air operators, most global airlines are still seen to keep tabs of the volatile crude oil prices prior to further burdening air travel-ers. While governments scramble to institute short-term measures, including sending more envoys to the Middle East, hoping things will cool off, all signs point to the likely surge of crude oil beyond USD 80 per barrel. When that happens, airlines will undoubtedly suffer with higher fuel bills. Several are already contemplating receivership protection initiatives. It is common knowledge that fuel bills range from 40% up to 65% of an airline's total cost, depending on type of fleet, engines and sectoral network. Barely a week ago, Brent crude hit USD 78 and is likely to hover around USD 78-79 this week. In a typical knee-jerk response, Cathay Pacific and six other airlines from China wasted no time in announcing a 7% raise in ticket surcharges beginning August 1, 2006. Among the six include three of China's largest carriers, i.e. China Southern Airlines, Air China Ltd and China Eastern Airlines Corp, all of which announced im-pressive fleet expansion plans with predominantly Airbus A320 aircraft.

If the average traveler thought it couldn't get any worse, the raising of airfares is now seen as a viable practice to help ailing airlines stay afloat, conven-tional of those who recently joined the low cost carrier (LCC) bandwagon. For instance, low cost carrier Southwest in the US raised airfares to protect profit margins by between USD 3 and USD 70 on its long-haul flights as a result of the oil spikes. Some analysts opine that it is a more healthy industry prac-tice to increase airfares strictly attributable to fuel, as opposed to implement fuel surcharges, which is in essence, a hidden charge. With regards to the local trend, Malaysia Airlines (MAS) said that while escala-ting oil prices remained a concern for all transport operators, it would be unnecessary to impose fuel surcharges based on premature speculations alone, or even the quantum at this point of time. MAS has always insisted that its fuel hedging policy ensures that it would be no worse off than other airlines, as long as fuel surcharges are imposed at levels that are in line with other carriers. In spite of these rising crude oil prices, MAS remains in an enviable position given that it has hedged 73% of its fuel needs for the fiscal year 2005/2006 at USD 58 a barrel. In addition, it has rationalized its international and domestic network and as a result, its fuel needs is likely to be contained with reduced weekly flight frequencies.

In stark contrast, rival Air Asia has yet to hedge its fuel requirement after June 2006. The LCC's basic prem-ise is that if there are spikes, there are bound to be dips as well. Still, recent announcements by Air Asia management indicate that the carrier is only waiting to hedge its future requirement, although pledging to refrain from imposing additional fuel surcharges in the immediate future. In turn, MAS claimed that the best defense an airline had against high fuel prices was to drive both passenger and revenue growth whilst maintaining fiscal prudence, in addition to creating new ways to drive savings. As part of its turn-around plan, MAS claimed to have been aggressive-ly exploring other various options to mitigate this risk and also to manage other controllable costs. These initiatives include fuel-hedging policies, imposing fuel surcharges, more careful adherence to the imposi-tion of excess baggage charges and streamlining of processes for greater efficiency. It has also improved fuel management capabilities via the fuel-efficiency task force, estimating to result in savings of up to RM 20 million this year, to be achieved via changes to load and flight planning, and improved flight crew standard operating procedures.

Aside from the initiatives of the industry's main players, the Government has also decided to assist by agreeing to further reduce passenger service charges departing from the low cost carrier terminal (LCCT) as a means to further boost volume. This move affects passengers who have to pay for international flights via the low cost carrier terminal. The argument is that because the terminal is built for low cost carriers, the rates charged to passengers should likewise also be low. A point of contention here nevertheless is that the airport tax charged by low cost carrier terminals in other countries is lower than that charged by the LCCT. For instance, Singapore, which only recently opened its Budget Terminal at Changi, claims that the terminal has the lowest international passenger charges. In addition, LCCTs around the world are known to provide discounts of at least 50% for other airport charges, ranging from parking to counter check-ins. As a matter of fact, several LCCTs in Europe are known to provide either free landing charges or institute discounts that start from 90%. Most airports have incentive schemes via rebates to encourage airlines to bring in a higher volume of passengers as the bulk of LCCTs are passenger-driven. This is just business sense as the LCCTs' lower charges generally reflect the very basic facilities provided to airport users namely the airlines and their passengers and the business model of low cost carriers. Most of these LCCTs even guarantee that the food and merchandise sold at the retail outlets are no higher that what the retailers would charge at their other outlets as well in departmental stores and supermarkets.

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The desperation for LCCs to further reduce costs due to the fuel spike is probably best summed up in the recent seemingly ridiculous proposal of 'standing-room seats'. Barely a month ago, major aircraft manufacturers, Boeing and Airbus have both admitted receiving queries from Asian LCCs in finding solutions to maximize passengers into economy class. While the airlines remain too embarrassed to state specific figures, a lot more seats are in the pipeline if that idea should come to pass, i.e. standing-room only seats. Still, even short of that option, European carriers have already been slipping in another row or two of seats in coach by exploiting stronger, lighter materials developed by seat manufacturers that allow for slimmer setbacks. The thinner seats can theoretically be used to give passengers more legroom although in practice, the airlines have been known to retain the same amount of space between seats to accommodate these additional seats. The result is an additional six seats on a typical Boeing 737, still the world's most successful civilian airliner, and as 12 new seats on a Boeing 757.

Conversely, Airbus has also been quietly pitching the standing-room-only option to Asian carriers, though none has agreed to specific designs. The proposal essentially states that passengers in the standing section would be propped against a padded backboard and held in place with a harness. That the airlines are even considering what many feel is the unthinkable is the result of several factors. Primarily again, high fuel costs are to blame for making it more and more difficult for fledgling airlines to turn a profit. The only benefit perhaps from the new 'thin' seat technology is that it now not only allows airlines to add more places for passengers, but also reduces the seat's weight by up to 7 kg, hence limiting fuel consumption. With the typical economy class seat now weighing between 25 to 38 kg, there is clearly added pressure on carriers to make the total passenger count as efficient as possible.

In spite of these mitigating measures, it is evident that crude oil at USD 80 per barrel is the maximum of that which is sustainable in the industry. Beyond that, say at USD 100 per barrel, it is evident that many aircraft would be grounded, resulting in further increases in fuel surcharges and ultimately, airfares. In that event, demand for air travel would be affected by reduced real disposable incomes. In March 2006, International Air Transport Association (IATA) has already alarmed the industry by issuing a statement that soaring oil prices could leave global airlines nursing a loss of USD 5.5 billion this year, and that collectively, airlines are likely to spend USD 76 billion on jet fuel by this year end. When comparing the expenses airlines would have to incur, (i.e. versus USD 63 billion in 2005, and USD 44 billion just a year before), the outlook for LCCs remain somewhat bleak in the immediate future. □

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