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LCCs USING GDSs AND CODESHARES:

A STUDY ON THE INCREASING COMPLEXITY OF THE LCC BUSINESS MODEL

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GDS DISTRIBUTION AND CODESHARES:

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The first low-cost carriers (LCCs) took an easy approach: They made the product 'flight' available to the most price-sensitive customers by following Porter's generic strategy of cost leadership.[1] But in order to continue to grow and operate profitably in a saturated market, many budget airlines have perceptibly changed their strategies by increasing complexity over the last few years. *PROLOGIS* and *ch-aviation* analyzed the trend of carriers following a low-cost approach to (1) add indirect distribution and (2) extend their networks through partnerships to gain access to new customer groups.

ADDING COMPLEXITY

The basic business model of a low-cost carrier is to operate with the lowest possible costs. Sales through indirect distribution, frequent flyer programs, partnerships and other measures aimed at increasing revenue are thus not allowed for with the pure LCC model. These factors simply raise complexity costs. Interlining, for instance, generates extra revenue, but is associated with high processing costs due to complex rules and regulations. Nevertheless, in recent years, more and more LCCs have changed their strategies and started adding these 'cost drivers' with carriers like Brazil's *Gol* or Germany's *germanwings* now codesharing and interlining with various local and overseas partners. And even Michael O'Leary just announced his plans to take a new strategic route with Ryanair by *"[…] rolling out a product specifically tailored for business travelers […]."*[2] Currently, the Irish carrier is still one of the few remaining so-called ultra-low-cost carriers (ULCCs) alongside *Lion Air*, *AirAsia*, *IndiGo*, *Cebu Pacific Air*, *Spicejet*, *Wizz Air* or *Spirit Airlines* as the world's major ULCC players – a model that is today more predominant in emerging markets like Asia.

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1 Porter, M. E. (1985)

2 Berry, M. (2013)

TOWARDS A HYBRID APPROACH

Due to the increasing hypercompetitive pressure in the short- and medium-haul markets of Europe, North America and Asia, many airlines that originally followed a low-cost approach were forced to develop their business model during the 2000s to continue to grow and operate profitably. At the same time, many legacies cut their services and simplified their fare structures to address more price-sensitive customers. In search of additional revenue and higher yields, LCCs started addressing passengers who were willing and able to pay higher fares, i.e. corporate customers.[3] Those passengers require better services, higher on-time performance, better flight connections and centrally located airports. The hybrid carrier was born. *Vueling* and *Norwegian*, for example, are no longer traditional low-cost airlines and can rather be referred to as hybrid carriers instead.

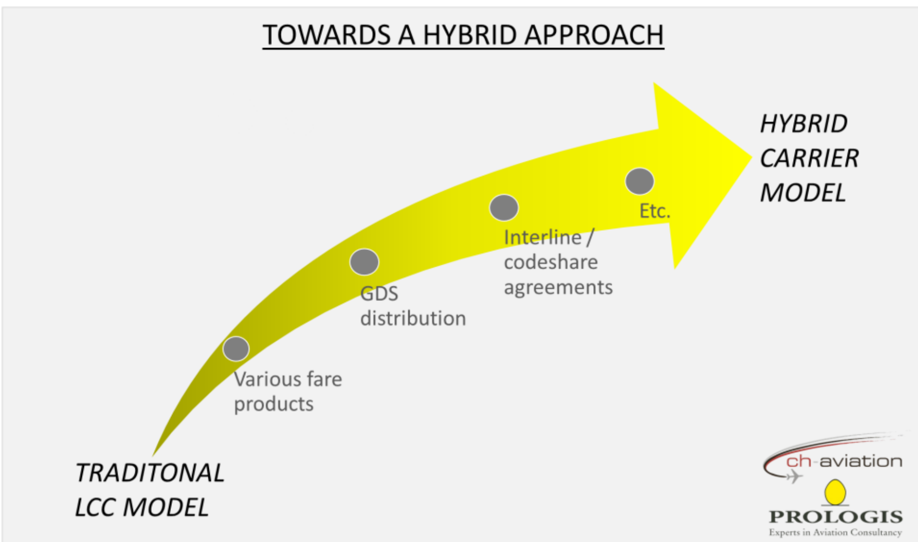

Figure 1

It's not always straightforward to separate LCCs from hybrid carriers. A hybrid carrier can be described by combining low operational costs with enhanced distribution processes, which, in most cases, allow bookings via Global Distribution Systems (GDSs). *Southwest* was one of the first carriers to apply this kind of business model. The idea of offering different bundled fare products is a very important innovation introduced by hybrids. This can be a "saver package" consisting of the flight only or a "premium package" including preferred boarding, seat selection, enhanced

[3] Holloway, S. (2008), p. 345

check-in options, food and beverages as well as other amenities. Furthermore, many hybrid carriers offer connecting flights (e.g. *Southwest* and *jetBlue* in the US, *Norwegian*, *Vueling*, *Pegasus* and *germanwings* in Europe). And the connections are not just limited to the airline's own flights. Hybrids also started investing in interline and codeshare partnerships.

DEVELOPING COUNTRIES: LCCs REMAIN LCCs

Whilst for LCCs in Europe, Northern America, Australia and other mature economies, the hybridization trend is obvious; other regions of the world seem unaffected by these changes so far. In India, for example, there are still two clear airline models: low-cost and full-service. The country has five major low-cost carriers: *IndiGo*, *GoAir*, *SpiceJet*, *Jet Konnect* and *Air India Express*, while *Jet Airways* and *Air India* are serving the legacy market. Together, the LCCs hold a domestic capacity share of 62% – one of the highest numbers worldwide. The reason why a trend towards a hybrid model cannot be observed so far is that, in the developing markets, there are basically only two types of customer groups: (1) Travelers who are both willing and able to afford flights with very high service standards and (2) travelers who can hardly afford low-cost flights and are much more price-sensitive. In general, the percentage of the population that does not travel at all by air remains high in developing countries. Yet, it will be interesting to follow the air traffic development in these markets over the next few years. India, for example, is assumed to become the third largest aviation market by 2020.[4]

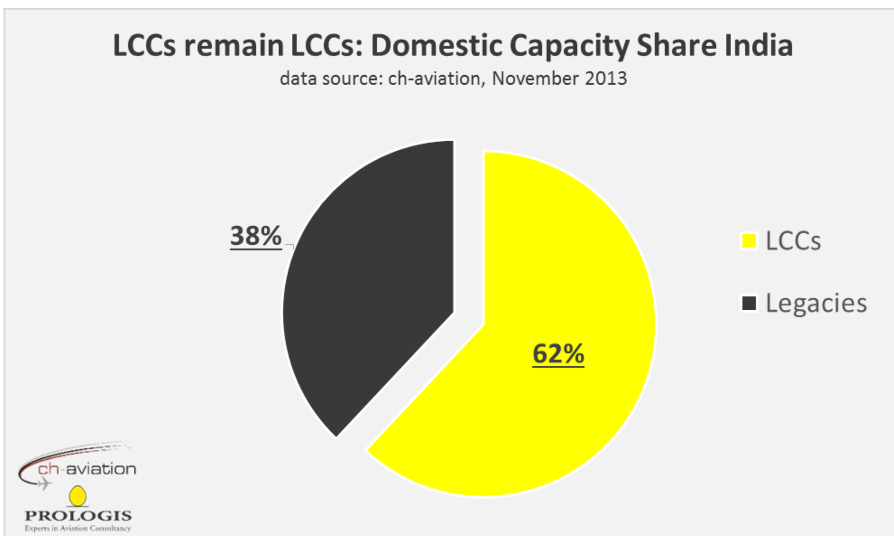

Figure 2

[4] Ministry of Civil Aviation, India (2013)

GAINING ADDITONAL REVENUE

Today, it is oftentimes simply the prospect of higher profit that convinces LCCs to become more hybrid. Expanding distribution channels to GDSs and entering into interline and codeshare partnerships with other airlines are two important drivers for hybrid carriers to gain additional revenue, next to ancillary sales. While the first of these two drivers is taken in order to be able to sell higher priced fares, the second enables airlines to increase demand on specific routes and gain access to new markets.

LCCS IN THE GLOBAL DISTRIBUTION GAME

GDSs have been the interface between traditional agencies with physical sales offices and airlines for several decades. *Amadeus*, *Galileo/Apollo* and *Worldspan* (the latter two owned by *Travelport*) as well as *Sabre* are some of the largest systems. Due to high booking fees, carriers sticking to the original LCC model have traditionally avoided this means of indirect distribution. However, it is quite common for business travelers to organize their bookings through travel agencies, which, in turn, use GDSs to query flight schedules and fare information to finally make seat reservations.[5] Thus, in order to gain access to this less price-sensitive customer segment at the sales level, hybrids have adopted GDS distribution. When *easyJet* started addressing the corporate customer segment, it added GDS sales (via *Amadeu*s and *Galileo*) as the first carrier that was originally classified as a pure LCC in 2007.[6] The above mentioned “big three” of the GDS market have since battled to attract more and more LCC business. At around the same time as *easyJet* began using GDS distribution, it was *AirTran* that started integration via XML with *Sabre*. A win-win innovation at first, this rapidly became a popular solution for airlines interested in having GDS presence without the costs this usually incurs. *Amadeus* took this even further in 2011 with the launch of their *ePower* product: On a web interface designed for travel agents, it brings together both the legacy, ATPCO connected airlines and the low-cost, XML connected players. In April 2013, they were followed by *Travelport* with their *“Merchandising*

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[5] GAO - U.S. General Accounting Office. (2003)

[6] Holloway, S. (2008), p. 345

solution platform." From the position of being shunned upon by LCCs, GDSs are becoming day-one partners for new entrants, as the example of *Volotea* and *Amadeus* showed[7] starting in April 2012.

During the last decade, we have seen a boom in airline bookings made directly over the Internet. Nevertheless, the last few years have shown that the trend is reversing and GDSs are recovering some of that lost share. Enhancements to the distribution flow (like *easyJet* did recently with *Amadeus* to allow for better ancillary integration) clearly show that the providers are working on overhauling their infrastructure, coming up with better price offers to LCCs and more advanced products. In the meantime, the entire industry is waiting to see whether IATA's *New Distribution Capability (NDC)* program will gain sufficient momentum.

ANALYZING TODAY'S GDS DISTRIBUTION

How many LCCs or hybrid carriers are actually using the GDS as a sales channel today? In the second decade of the 2000s, it was assumed that nearly 50% of all budget carriers were already using GDS distribution.[8] *PROLOGIS* and *ch-aviation* analyzed today's GDS distribution landscape based on *ch-aviation* data from November 2013 and found out that about 61% of all LCCs and hybrid carriers distribute their seats through at least one GDS (see Figure 3). When classifying LCCs and hybrids, we excluded all types of regional carriers, which left us with a total of 90 LCCs/hybrids of which 55 have a GDS connection.

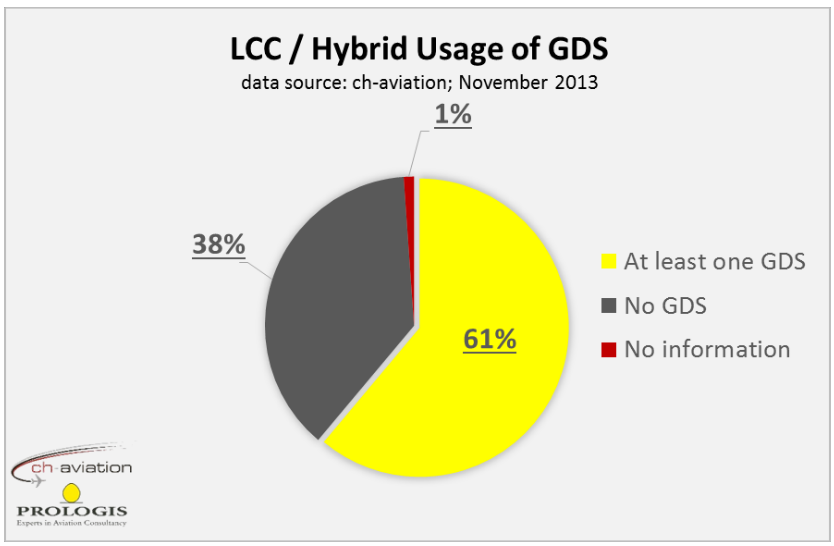

Figure 3

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[7] Jorre, A. (2013)

[8] Holloway, S. (2008), p. 356

COLLABORATING LCCs AND HYBRIDS: A TREND TOWARDS INTERLINE AND CODESHARE AGREEMENTS?

Just as GDSs have been part of the legacy carriers' sales strategy for a long time, so have interline and codeshare agreements. If an interline agreement is in place between two airlines, they accept tickets issued by the other airline and/or allow the other carrier to issue tickets for its own flights.[9] When it comes to codeshare agreements, the marketing aspect is added. In its very basic model, a flight operated by carrier X can be marketed by its codesharing partner Y. While carrier X, labeled as the 'operating carrier', offers the flight under its two letter designator code and flight number, carrier Y, labeled as the 'marketing carrier', also markets the flight with its own carrier information. The 'ticketing carrier' who issues the ticket (thus also known as the 'issuing carrier') can vary from the 'operating' and 'marketing' carrier. Carriers can enhance their customer reach and expand their customer offerings through both interline and codeshare agreements.[10]

AN ANALYSIS OF THE CODESHARE DEVELOPMENT

PROLOGIS and *ch-aviation* analyzed the development of collaborating low cost and hybrid airlines over the last ten years to learn whether the assumption of an increasing trend towards joint ticket distribution of budget carriers can be confirmed by market data. We decided to use codeshare data, because, unlike interline agreements, codeshare agreements can easily be captured based on schedule data. The codeshare information was taken from *Innovata* and *ch-aviation* data that included the weekly capacities for September 2003, September 2008 and September 2013. We took all worldwide codeshares between a LCC/hybrid carrier and both another LCC/hybrid or scheduled carrier under consideration in our analysis. Again, we omitted all regional airlines from this carrier classification. This resulted in a search for codeshare agreements amongst 46 LCCs/hybrids in 2003, 84 in 2008 and 90 in 2013.

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[9] Beaver, A. (2005), p. 203f.

[10] Steer Davies Gleave (2007)

Based on the absolute numbers, the trend towards codesharing LCCs/hybrids has increased significantly: While only six LCCs/hybrids had codeshare agreements with other airlines in September 2003 (*Flybe.*, *SkyEurope*, *Virgin Blue*, *Virgin Express*, *Volare* and *Zip Air*), exactly ten years later, the number has increased by more than fourfold to up to 26. Despite the fact that the number of LCCs/hybrids on the market has approximately doubled over the last decade, we can still observe a relative increase of codesharing LCCs/hybrids by about 16% from 13% (2003) to almost 29% (2013) (see Table 1).

Codeshare Development	2003	2008	2013
TOTAL LCCs/hybrids	46	84	90
Codesharing LCCs/hybrids	6	10	26
Codesharing share	13.04%	11.90%	28.89%

Table 1

It is interesting to notice that, in relative figures, the share of codesharing airlines dropped by about 1% between 2003 and 2008 for all LCCs/hybrids. Hence, according to our study results, the trend towards increasing LCC/hybrid codeshares can be traced back to only the years between 2008 and today (about 17%).

MARKETING VERSUS OPERATING CARRIERS

Do LCCs/hybrids use codeshares mainly to increase passenger numbers on their own offered routes – i.e. by acting as the operating carrier or do they also apply the idea of extending their network by booking passengers on their partners' routes – i.e.

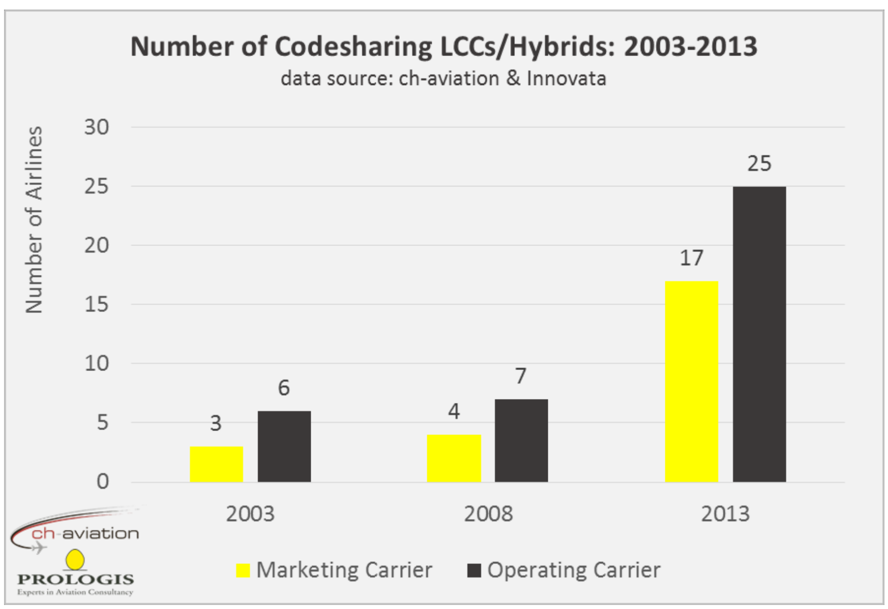

Figure 4

by acting as the marketing carrier? Looking at absolute airline numbers, our analysis results show that in 2003, 2008 and 2013, there were more LCCs/hybrids acting as operating carriers than as marketing carriers (see Figure 4). Today (Sept. 2013), there are ten LCCs/hybrids who only act as operating carriers (*Eastar Jet*, *germanwings*, *jetBlue, Jetstar Airways*, *Jetstar Asia Airways*, *Jetstar Japan*, *Mango*, *Norwegian*, *Transavia* and *Vueling*). Most of these airlines are subsidiaries of or partly owned by major scheduled legacy carriers with which they have codeshare agreements, themselves being the operating carrier. One exception is *Eastar Jet* who carries customers of fellow South Korean LCC *T'way Air*. *T'way Air* along with *Lion Air* are, in turn, the only budget airlines that solely act as marketing carriers (based on our carrier classification). The other 15 carriers have both agreements as marketing and operating carriers.

When we examine the codeshare capacity in September 2003, however, we see that the weekly seats offered by marketing carriers (162,399 seats/week) exceeded the number offered by operating carriers (155,232) at the time. In 2008, though, the distribution had changed with a capacity of 233,705 seats/week offered by marketing carriers and 347,684 seats/week offered by operating carriers. Today, the capacity by operating carriers (4,423,588) exceeds the marketing carriers' (3,051,959) by almost 1.4 million seats/week (see Figure 5).

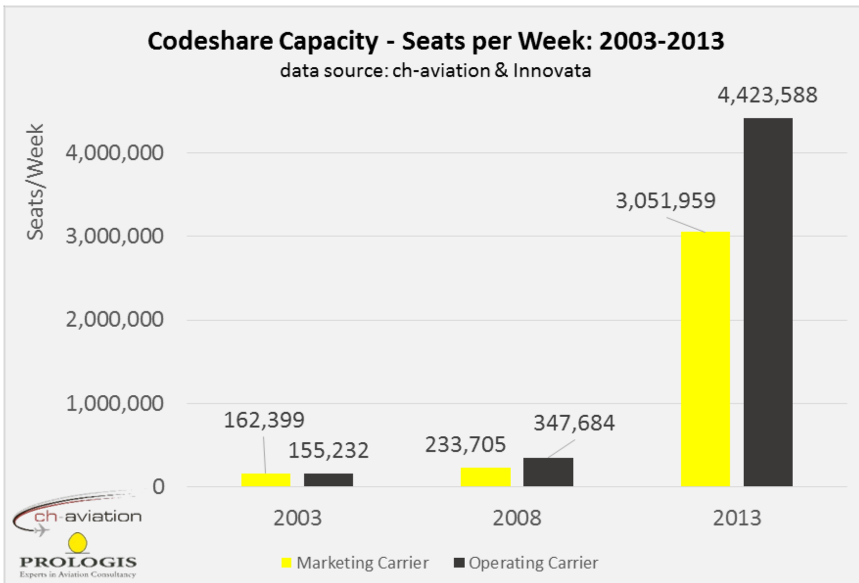

Figure 5

THE EFFECTS ON PASSENGER SERVICE SYSTEM (PSS) SELECTION

More than half of today's 90 LCCs/hybrids are served by only two PSS vendors: 42 are hosted by *Navitaire* and 10 by *Sabre*, according to the *ch-aviation* airline IT vendor database. The PSSs *Hitit*, *IBS*, *ISA*, *Mercator*, *Radixx*, *Results*, *SITA*, *Travelsky* and *Videcom* are used by at least two

LCCs/hybrids from the *ch-aviation* database. The level of readiness for bilateral interline and codeshare agreements by these smaller PSS providers varies. Thus, carriers interested in becoming more hybrid must sometimes migrate to another PSS solution as part of their strategy change.

CONCLUSION AND OUTLOOK

Our study results show that there indeed seems to be a trend away from the original LCC approach of simplicity towards more complexity. In this study, we focused on GDS distribution and codeshare agreements, which in Europe, North America and Australia seem to belong to LCCs and hybrid carriers just the same as to legacies nowadays. Of course, these two factors are not the only ones indicating that LCCs have started to make their business models more complex. Ancillary sales would definitely be yet another factor to take into consideration. Nevertheless, this is a complex topic on its own which will be discussed by *PROLOGIS* in a new study to be published in the spring of 2014.

We mentioned earlier how difficult it is to distinguish between an LCC and a hybrid carrier. But isn't it also becoming more and more difficult to distinguish between a hybrid and a network carrier? With the once merely price-focused airlines adding more services, using GDS distribution and partnering with competitors, on the one hand, and the traditional legacy carriers simplifying their business strategies and trying to address more price-sensitive customers on the other, it is harder to keep them clearly apart. Our study provides a reason to believe that the originally distinct carrier models are increasingly converging. This applies for both their internal organization and their processes: The outlined developments towards indirect distribution and interline agreements, for example, significantly affect the revenue accounting processes of these LCCs and hybrid carriers – another interesting topic to be discussed in one of our papers that will be published next year. Today, positioning yourself 'in the middle' of Porter's cost and differentiation strategy seems to be a favored and perhaps even successful approach for airlines – as long as one does not get 'stuck', but rather remains flexible to be prepared to move on within the ever changing aviation industry.

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