INSIGHTS

Tough Times, Tough Measures for Airlines and Travel Buyers

How will trouble in the aviation industry impact the corporate travel program?

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"The situation is desperate… Airlines are struggling for survival and massive changes are needed," warned Giovanni Bisignanni, director general of the International Air Transport Association (IATA) in June. Sky-rocketing fuel prices, slowing demand and increased competition are putting pressure on airlines worldwide, especially those with aging fleets, little or no fuel hedging and small cash reserves. Among the hardest hit, U.S. carriers have responded with capacity cuts and pricing changes that are likely to spread to other regions in time. This article examines these changes and discusses the implications for the corporate travel program.

Just how tough are times?

The news for airlines gets worse every day as fuel prices continue to rise. Having broken all previous records since January this year, crude oil reached US$139 per barrel[1] at the beginning of June, while refined jet fuel costs on average US$161 per barrel, up 90 percent on the same period one year ago.[2] Fuel now accounts for approximately 40 percent of airline costs and according to IATA, for every dollar the price of oil goes up, carriers pay an extra US$1.6 billion.

At the same time, the economic slowdown in the United States has softened demand for air travel. According to traffic figures published by IATA for April, revenue passenger

[1] Source: International Energy Agency
[2] Source: IATA weekly Jet Fuel Price Monitor

kilometers have grown more slowly than expected, with 4 percent average growth worldwide, almost half the pace at the end of 2007.

In addition, airlines face increased competition both from companies with new aircraft capacity and greater market liberalization worldwide. Notably, 25 percent more transatlantic flights are due to take off this year following the open skies agreement between the European Union and the United States.

Together, these three trends are putting pressure on airlines' bottom line. If crude oil prices remain above US$100 per barrel, IATA expects airlines to collectively lose US$2.3 billion in 2008, drastically downgrading the profit forecast made earlier in the year. Many carriers have also made gloomy observations. For example, American Airlines said in May that it is losing US$3 million per day although "doing a lot better than a lot of the other guys."

Cost-cutting and changes in pricing

Tough times require tough measures and airlines have stepped up their cost-cutting initiatives. In particular, major U.S. carriers have announced plans to cut domestic/regional capacity by using smaller aircraft and reducing the number of daily flights. United Airlines, for example, says it will cut 14 percent capacity by the end of the year, while also scrapping its low-fare Ted brand. Delta intends to cut 13 percent by year end, American Airlines 11-12 percent, Continental 11 percent, US Airways 6-8 percent and Northwest 5 percent. Similarly, Australia's Qantas has grounded six jets serving domestic and international routes. Further announcements may well follow in Europe by the end of the year.

Airlines have also introduced changes in pricing, ranging from increases in fares and fuel surcharges to new fees for "unbundled" services that were previously included in airfares:

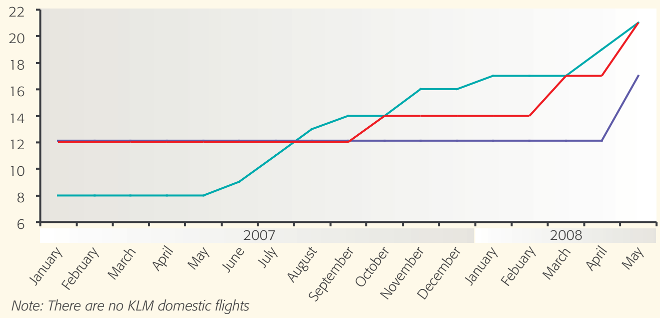
- **Fare hikes.** Although carriers claim they are reluctant to raise fares, they also say they have no choice. U.S. airlines have already attempted more than a dozen price hikes between January and May. CWT data shows U.S. fares rising in the first quarter of this year after a downward trend in 2007.
- **Introduction of fare "floors."** For example, US Airways announced in April that it would cancel all non-sale fares under US$69 on short-haul flights.
- **Reintroduction of Saturday-night-stay restricted fares and tougher minimum-stay requirements.** Since last fall, most U.S. carriers have reintroduced Saturday-night-stay requirements and in some cases, tougher minimum-stay restrictions on cheaper fare classes. For example, Northwest has raised minimum stays from zero or one night to two nights and from two nights to three on many fares.
- **Higher fuel surcharges.** Carriers worldwide have regularly increased surcharges. In May for example, JAL said it would raise its surcharge for flights to and from the United Kingdom from US$180 to US$253 per sector—in other words, an increase

of 40 percent from one month earlier. Meanwhile, Virgin Atlantic applied different surcharge increases to each of its travel classes, making premium passengers pay more. The chart below shows the surcharge hikes on several major European carriers since 2007.

Fuel charges have risen sharply since 2007

Fuel surcharges for domestic flights

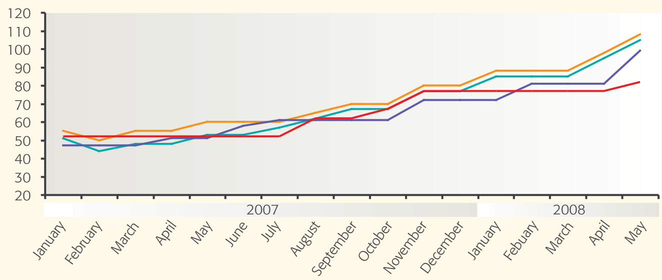
(Per segment in euros) January 2007 - May 2008



Note: There are no KLM domestic flights

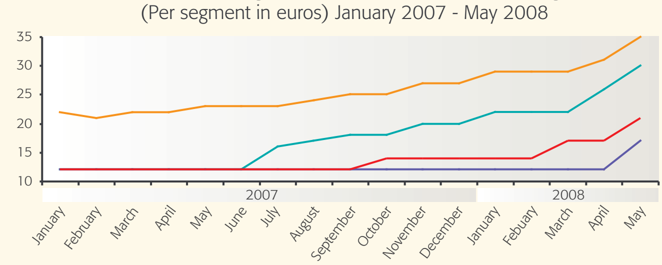
Fuel surcharges for international flights

(Per segment in euros) January 2007 - May 2008



Fuel surcharges for intracontinental flights

(Per segment in euros) January 2007 - May 2008



Fuel surcharge trend for intercontinental flights

January 2007 - May 2008

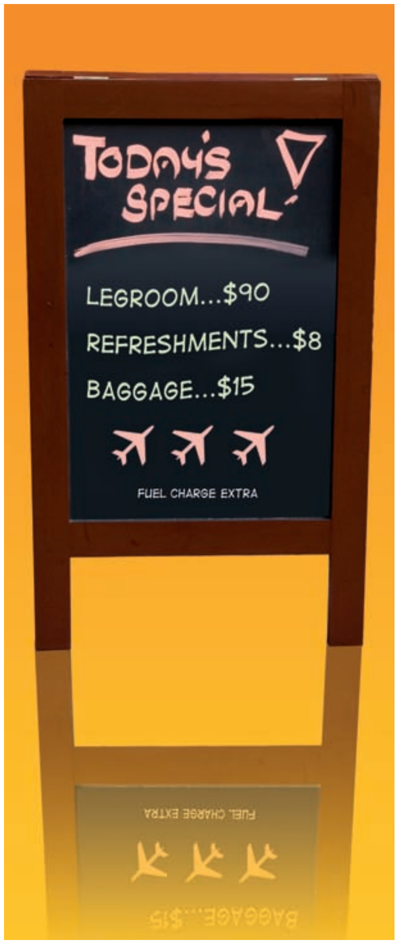
Air France	**+98%**
KLM	**+80%**
British Airways	**+94%**
Lufthansa	**+58%**

Source: CWT Travel Management Institute

- **Increased fees for changes or cancellations.** In April, United Airlines raised its domestic fee by US$50 to US$150 and Continental followed. US Airways also charged US$150 while Delta raised its fee by US$25 to US$100.
- **New TMC charges for inactive segments that are not removed from passenger name records within 24 hours of a flight's departure**. American, Continental, Northwest and United have all introduced similar fees (typically US$3.50 per segment and a US$50 service fee), while US Airways has introduced a policy that could lead to fees. This practice has not yet emerged in Europe but should not be ruled out.
- **New charges for services previously included in fares.** Earlier this year, North American carriers introduced a range of optional service fees. These include a US$25 fee for a **second checked bag,** introduced by the six main U.S. carriers, which was followed by a US$15 fee for the first checked bag (American Airlines, United Airlines and US Airways). US Airways also introduced a US$5 charge for "**Choice Seats**"—aisle or window seats in the first several rows of the coach cabin and a US$2 fee for beverages in its coach cabin. Meanwhile, Air Canada started charging US$25-35 for an "On My Way" **helpline service** for travelers wishing to book alternative flights in the event of a delay or cancellation.
- **Higher charges for existing optional services**. For example, Delta has raised the price of a one-visit lounge pass by US$5 to US$30. Other charges raised by airlines include overweight baggage, bookings through airline sales agents, unaccompanied minors and pet transport.

Charging for more and more **optional services** is a trend that looks set to continue. Already last July, a global survey published by U.S. consulting firm IdeaWorks revealed that 63 percent of surveyed airline executives agreed "unbundling is becoming more prevalent." For example, 53 percent expected pre-assigned premium seats (e.g., exit row) to be charged in the future, compared with 29 percent who have already introduced this charge. Other items that are likely to be sold more often as optional extras include onboard meals, online payment by credit card and in-flight entertainment. In effect, the line is blurring between legacy and low-cost carriers as both seek to increase revenues from ancillary services (i.e., those that are not included in the fare).

How do these changes impact the travel program?



The most pressing issue for many travel buyers is how to **manage rising air travel costs** at a time when budgets have been restricted. A recent survey[3] of U.S.-based travel managers published by UBS Investment Research indicated that 42 percent of the 80 respondents intend to cut back on air travel more so than last year. In this context, demand management will take on increasing importance and some CWT clients in North America have even introduced travel bans to keep spend within targets. For the moment, however, CWT data shows robust demand for travel in Europe and Asia Pacific.

In addition to higher ticket prices and fuel surcharges, companies can expect higher costs linked to **increased complexity in the booking and expense management process**. Most unbundled services are not yet available through global distribution systems (GDSs) and online booking tools because of the technological complexity required to handle them. While some optional services are complementary for frequent flyers or business class travelers, others need to be bought at the airport (e.g., extra baggage or lounge passes) or in-flight (e.g., meals). Others still are included in fares that are only available on airline Websites. Galileo, Amadeus and Sabre are all developing capabilities for carriers around the world to offer unbundled services through their GDSs, but these will not be available immediately. Amadeus, for example, plans to launch unbundling functionalities in 2009.

[3] The lastest bi-annual *Corporate Travel Management Survey* published by UBS investissement research in a *U.S. Airline Sector Note* (May 1, 2008)

In the meantime, companies may wish to consider the implications of new optional services for their **travel policies and expense management processes**. Which extra services should be authorized for which type of flight or traveler? How will policy updates be communicated? And which actions (e.g., communications and training) will best promote traveler compliance? Travel buyers can also explore opportunities to **negotiate preferential prices** on specific services or include them in corporate fares.

Last but not least, any capacity cuts could mean less choice for travelers in terms of schedules and routes, as well as fuller planes and longer waits between connecting flights. Travel managers will need to monitor changes and make any necessary adjustments to their travel program to ensure an appropriate level of **service and comfort** for employees.

All in all, capacity cuts, significant airfare hikes and an abundance of new charges promise to make travel management more complex over the coming months. Cost-cutting measures taken by North American carriers may well be implemented in other regions as airlines worldwide seek ways to limit losses and companies clamp down on spending. More tough times may be ahead—not just for airlines, but for companies and their travelers. n

High prices drive fuel efficiency

Record-high oil prices have provided an extra incentive for airlines to improve their fuel efficiency and reduce aviation's impact on the environment. This is a key concern for the International Air Transport Association (IATA), whose members have committed to a 25 percent improvement in fuel efficiency by 2020. Among the initiatives being implemented are:

- **Investments in newer aircraft and equipment.** Thanks to new technology, new aircraft are 70 percent more fuel efficient than 40 years ago and 20 percent more efficient than 10 years ago. Notably, the A380 and B787 superjumbos aim for 3 liters per passenger kilometer—more efficient than a compact car. In addition, airlines are retrofitting existing aircraft with new equipment such as more efficient fan blades and winglets that lower aircraft drag.
- **Operational improvements**. A wide range of improvements include, for example, reducing flight cruising speed, using ground equipment to move aircraft between gates, taxiing with only one engine, regularly washing aircraft to reduce drag, removing unnecessary weight and switching to lighter equipment.
- **Improved air traffic management**. IATA estimates that better airspace design, procedures and management could save one minute per flight, significantly reducing fuel consumption.
- **Alternative fuels.** The industry is testing alternatives to kerosene, including synthetic fuel blends and biofuels. In addition, IATA has partnered with Solar Impulse, a Switzerland-based project to build a solar-powered aircraft.