

# DOWN TO EARTH

## “IDEAWORKS AISLE”

### Europe's Top 4 Low Cost Carriers Generated €470 Million From Ancillary Revenue Sources in 2005...

But U.S. frequent flier programs produced revenues estimated at €2.5 billion and better per passenger results.

Revenues from non-ticket sources, which are called ancillary revenues, have become an important financial component for low cost carriers (LCCs) in Europe and throughout the world. **Michael O'Leary**, Chief Executive of **Ryanair**, Europe's largest LCC, wants to offer free airline tickets by replacing traditional ticket sales with revenues produced by ancillary activities. His statement reflects how Europe's LCCs have morphed the **Southwest Airlines** model of providing overall value into an a la carte style of offering ultra-low fares and charging consumers for services such as checked baggage.

**Mr. O'Leary** needs to add a frequent flier program if he wants to squeeze more revenue from non-traditional sources. **IdeaWorks** estimates **Ryanair's** aggressive use of a la carte pricing generated ancillary revenues of €7.76 per passenger, while United's Mileage Plus frequent flier program posted amazing results of €9.40 per passenger. Even US-based LCCs are realizing attractive ancillary revenues from their relatively young programs. For example, the co-branded credit card linked to Frontier's EarlyReturns program contributed revenues of €19.6 million during 2005.

In practice, ancillary revenues are often the a la carte services and features that passengers may purchase before or during their travel experience. Legacy airlines bundle these services into the price of an airline ticket. LCCs, and especially those outside the United States, tend to un-bundle the travel experience. Under this scenario, consumers purchase basic airline transportation and may pay extra for services such as advance seat assignments, checked baggage and onboard snacks and drinks.

The prevailing LCC model in the United States focuses on value - - providing good service at a fair price. For example, LCCs such as **AirTran**, **JetBlue**, **Frontier**, **Spirit**, **US Airways** and **Southwest** offer frequent flier benefits, free checked baggage, and do not charge extra fees for payment by credit card. Outside of the United States, LCCs emphasize ultra-low fares and often tie these services to the payment of additional fees.

by **Jay Sorensen**  
(President of **IdeaWorks**)



**Ryanair** led the development of LCCs in Europe and borrowed **Southwest's** original model of low fares and no frills. **Ryanair** has a reputation for ruthless cost cutting and charging consumers for services beyond basic transportation. On the expense side, it has removed tray tables and window shades to lower fuel and maintenance costs. On the revenue side it charges fees for checked baggage and for ticket purchases made via credit cards. LCCs in Europe and throughout the world have largely embraced **Ryanair's** mantra of cutting costs and charging service fees.

**Michael O'Leary's** vision of making flying free by 2010 has raised the profile of the ancillary revenues generated by LCCs. The investment community views robust ancillary revenues as an indicator of an effective and creative management team. **IdeaWorks** researched the financial statements of the more established LCCs in the world and found the following list "ancillary revenues" in their financial reports: **AirAsia**, **Air Berlin**, **easyJet**, **Ryanair**, **SkyEurope**, **Virgin Blue**, and **WestJet**.

This represents a clear distinction from the LCC experience in the United States, where the financial statements of U.S. carriers are largely silent on the issue. But some U.S. airlines report the revenues generated from their frequent flier programs. **IdeaWorks** believes these financial results should qualify as ancillary revenues. For major airlines, such as United and Alaska, these revenues are significant enough to warrant inclusion in Form 10-K annual reports. United attributed revenues in excess of €627 million to its Mileage Plus frequent flier program for 2005.

**IdeaWorks** retrieved ancillary revenue data from established LCCs in Europe, Asia and the United States as shown in the table. Alaska and United were included as representative of the results generated by major U.S. airlines that operate mature frequent flier programs.

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## Ancillary Revenues for 2005

Aer Lingus	€ 5.99	\$7.60
Air Berlin	€ 2.51	\$3.16
AirAsia <sup>1</sup>	€ 1.66	\$2.09
<b>Alaska</b>	<b>€ 8.55</b>	<b>\$10.89</b>
easyJet	€ 4.37	\$5.50
Frontier	€ 2.53	\$3.22
JetBlue	€ 0.37	\$0.48
Ryanair	€ 7.76	\$9.77
SkyEurope <sup>2</sup>	€ 4.38	\$5.51
<b>United</b>	<b>€ 9.40</b>	<b>\$11.98</b>
Virgin Blue <sup>3</sup>	€ 3.80	\$4.82
WestJet	€ 2.82	\$3.59

Europe's LCCs have been very creative in developing opportunities to encourage air travelers to spend money. Virtually all LCCs in Europe, and many of those elsewhere in the world, already allow consumers to arrange hotel accommodations, car rentals and trip insurance at their web sites. The airlines are paid a commission by third parties for each completed sale.

*Ryanair's* home page offers a virtual shopping mall experience with offers for car insurance, personal loans, pre-arranged airport parking, airport motor coach transfers, airport lounge access, co-branded credit cards, holiday packages, bed & breakfast stays, and golfing in Ireland. The airline has also turned its baggage service into a profit center. Checked baggage can be pre-paid at the time of booking at a cost of €4.50 per piece, or €10.00 if paid at the airport. Like many other

LCCs outside of the United States, *Ryanair* charges an additional fee for payment by credit card. The fee for MasterCard and Visa charges is €2.50 per passenger per flight. The fee is lower for debit card transactions and is waived for infant travelers.

Airlines all over the globe seek to emulate the ancillary revenue results obtained by *Ryanair*. The phrase has become popular with airline management and investors. *Aer Lingus* used the word "ancillary" more than 70 times in its recent public share prospectus. Major airlines, such as *British Airways*, now openly express the desire to increase ancillary revenues in their presentations to the investment community.

The analysis performed by *IdeaWorks* suggests even greater ancillary revenues may reside in an activity traditionally scorned by LCCs . . . frequent flier programs. United and Alaska have proven the financial power of these programs through results that approach €10 per passenger. These programs not only have revenue potential, they also make consumers more loyal to a brand. Ironically, these programs already allow millions of program members to enjoy the free flight sought by *Michael O'Leary* for the year 2010.

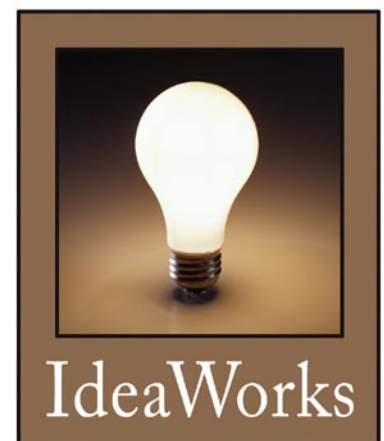
Sources used in this Industry Analysis: Unless otherwise noted, frequent flier program information presented in this report is based upon an online review conducted during October 2006 of airline financial filings, web sites, and communication with airline management. Currency exchange rates were calculated during October 2006 at the XE.com web site.

1. 518 million passengers were carried by U.S. major airlines during 2005. IdeaWorks estimates minimum frequent flier related revenues were €4.77 per passenger.
2. "A radical fix for airlines: Make flying free" Business 2.0 Magazine, March 31, 2006.
3. AirAsia estimates are for the AirAsia Group (Malaysia, Thailand, Indonesia) for the fiscal year ended June 2006 and reflect 8.4% of group revenues, as referenced in financial documents.
4. SkyEurope results are for the 9 month period ended June 2006.
5. Virgin Blue results are for the fiscal year ended September 2005 and reflect 4.9% of total revenues, as referenced in financial documents.

### Disclosure:

*IdeaWorks* makes every effort to ensure the quality of the information available in this report. Before relying on the information, readers should obtain any appropriate professional advice relevant to their particular circumstances.

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