A Cost Gap exists in each region, across a range of cost categories. In 2004, there was a 36% cost gap in terms of operating costs per available seat kilometre (ASK) for the three largest US network airlines versus Southwest. In Europe the gap was also high – at 40% versus Easyjet and 64% versus Ryanair – while 60-70% gaps also exist in Asia and South America. There are significant differences across a range of cost categories. For example, Ryanair has significantly lowered operational and distribution costs, while also fitting more seats on equivalent types of aircraft than the European network airlines (see Chart 1).

Network airlines have improved cost efficiency, but have yet to significantly reduce the cost gap. Major restructuring among US network airlines has seen the gap to Southwest narrow from 45% in 2001 to 36% in 2004 (see Chart 2). However, this convergence merely reversed the widening of the cost gap in the late 1990s. With Southwest enjoying a very stable cost base, the cost gap in 2004 was virtually the same as in 1996. European network airlines have reduced unit costs since 2001, especially on the sales and distribution side. Yet European LCCs have also reduced costs to a similar or even greater extent, while gaining revenue in some areas that are costs for the majors.

Some additional costs help to attract a revenue premium over the LCCs but they still must be delivered efficiently. European network airlines have managed to maintain a significant yield premium over the major LCCs, and have even expanded the premium as average yields fell from 2001 onwards (see Chart 3). By contrast, the revenue premium for US network airlines over LCCs is relatively low. The lower yield premium reflects relatively strong route-by-route competition with the LCCs in the US, but also reflects the difficulties many US airlines face in differentiating the quality of their product on domestic routes. Customers may perceive a larger difference between network airlines and LCCs in Europe than in the US, in terms of passenger service, network connections, frequencies and more convenient airports.
IMPLICATIONS
The emergence and growth of LCCs poses significant competitive challenges to the network airlines. Significant progress has already been made in improving cost efficiency – with progress given more urgency by the rise in fuel costs – though large cost gaps still exist with the major LCCs. Further progress in reducing unit costs is essential but a complete move to an LCC model is not. There are still many competitive advantages in an efficiently delivered, higher product quality network model.

1. Greater Cost Efficiency is already being achieved by network airlines.
US and European network airlines have managed to make progress in lowering unit costs (and particularly non-fuel unit costs) since 2001. Cost reductions, or at least stabilisation, have also been achieved by the network airlines examined in Asia and South America. A reduction in distribution and overhead costs has been the main driver, though cost efficiencies have also been achieved across several other cost categories. Nevertheless, the need for greater efficiency will be a dynamic and on-going process – the productivity improvements and cost efficiencies delivered since 2001, while impressive, are just the start.

2. LCCs can provide some important cost lessons for network airlines.
Even with efficiency improvements since 2001, there are still large cost gaps with LCCs in all four of the regions. Cost gaps exist across a range of labour, operational, infrastructure and overhead costs, though the nature of the gap can differ by region. For example, there is less of a difference in infrastructure costs in the US than other regions, with less opportunity for LCCs to concentrate on secondary airports. The size and distribution of the cost gap highlights there are several areas, from distribution to aircraft utilisation, where the network airlines can move closer to an LCC approach in order to lower costs. However, a wholesale imitation of the LCC model is only likely in a few cases to be both feasible and desirable.

3. Governments and Suppliers also have a role in achieving cost efficiencies
The large gaps in infrastructure costs, especially in Europe, and the persistence of "structural" gaps in other categories highlight the importance of Governments and the aviation industry as a whole helping to improve cost efficiency. Airports and suppliers must also proactively seek greater efficiency in their operations. Governments must allow airlines greater freedom to restructure their operations and ownership on a commercial basis.

4. However, the network model can also provide some competitive advantages
The higher product quality that can be offered by network airlines (e.g. network connections, flexibility, product comfort, more convenient airports, personal rewards through loyalty schemes) will incur some additional costs; though can also be used to attract customers willing-to-pay a premium for the additional service. "Efficient differentiation", whereby network airlines improve cost efficiency but not at the expense of reducing the quality of service to the target customer base, can address both the cost and revenue side at the same time.

5. Network airlines can adopt a pro-active response in regions when LCCs are only just emerging
For regions where LCCs are still in their infancy, network airlines should note how LCCs have developed the cost gap across several categories in other regions and respond proactively. In particular, where a route demonstrates the type of characteristics for entry by an LCC (e.g. steady, point-to-point traffic) an airline can seek to pre-empt competition by adopting an LCC-type cost approach, lowering fares and generating new demand. The emergence of LCC competition will often require significant structural changes for existing airlines and a shift in focus towards identifying and achieving cost efficiencies. However, in meeting the LCC challenge, existing airlines must not lose sight of the higher quality of service and customer benefits that they can offer, provided that the additional revenues generated by a higher level of service can exceed the additional costs incurred.

FULL REPORT
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