Abstract: This paper studies the factors influencing the profitability of European budget airlines through a detailed analysis of three airlines: Ryanair, EasyJet and SkyEurope. It begins by defining budget airlines and examining their origins in Europe. It then looks at previous studies that determine factors that influence the rate of return in aviation. It then undertakes a detailed analysis of the airlines’ performance from 2000 to 2008. The study concludes by identifying the factors that influence profitability in this industry. They are giving employees stock options, discouraging unions, outsourcing or relocating jobs to countries with lower labor costs, fuel hedging, adopting more fuel-efficient aircrafts, outsourcing maintenance to countries with lower labor costs, improving management, a clear cut business strategy, a high load factor, the ability to generate ancillary revenue, size, scale and first mover advantage.
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</tbody>
</table>
1.0 Introduction

Flying has traditionally been an activity for the elite. It was for important executives who believed that they were entitled to private lounges and champagne on board, and was an activity that most of the middle-class could only afford to undertake a few times a year. This was because inefficient national airlines were protected and promoted by states. Supply was tightly controlled and prices were high. When deregulation occurred in Europe, a plethora of low cost carriers entered the market. These airlines made flying affordable for the common man. Today, a student from London can buy a roundtrip ticket to Frankfurt for twenty pounds: for the same price as a meal or two cinema tickets. This essay will study the profitability of this remarkable new sector in aviation through the lenses of Ryanair, EasyJet and SkyEurope. It will begin by examining the characteristics of budget airlines and will then chronicle their origins. It will then look at a similar study on the determinants of the rate of return in aviation. It will then examine the performance of these three airlines in detail to determine the factors influencing the profitability of European budget airlines.

2.0 What are Budget Airlines?

A budget airline, also known as a low cost carrier, is an airline that offers lower fares than regular carriers. In exchange for this, budget airlines minimize costs by eliminating passenger services traditionally associated with regular airlines. Budget airlines have many of the following characteristics.
• One passenger class
• Smaller planes with more seats on a plane
• Fast turnaround times
• Point to point services (no transit passengers)
• Unreserved seating
• Flights to cheaper or secondary airports
• Flights at inconvenient times to reduce air traffic and to benefit from lower airport fees
• No frequent flier service or passenger lounges
• Charges for extra services such as meals on board, checked in luggage, flight changes
• High percentage of online sales thereby eliminating travel agents

All budget airlines do not have these traits and some regular airlines have adopted some of these measures to cut costs, but they provide a useful indication of how budget airlines work. As a result of them, budget airlines have significantly lower costs than regular airlines. The UK Civil Aviation Authority created a cascade study based on observed differences between budget airlines and traditional airlines in an attempt to show cost savings.¹ The study shows the cost reduction caused by each characteristic of a budget airline. As the table below shows, budget airlines on average have costs than are only 49% of those of regular airlines, which allows them to charge substantially lower fares.

¹ Doganis Rigas, The Airline Business, (Routledge, 2006, New York ) pg 171
<table>
<thead>
<tr>
<th>Operating advantages:</th>
<th>Cost Reduction (%)</th>
<th>Cost per seat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher seating density</td>
<td>-16</td>
<td>84</td>
</tr>
<tr>
<td>Higher aircraft utilization</td>
<td>-2</td>
<td>82</td>
</tr>
<tr>
<td>Lower flight and cabin crew costs</td>
<td>-3</td>
<td>79</td>
</tr>
<tr>
<td>Use cheaper secondary airports</td>
<td>-4</td>
<td>75</td>
</tr>
<tr>
<td>Outsourcing maintenance/ single aircraft type</td>
<td>-2</td>
<td>73</td>
</tr>
<tr>
<td>Product/service features:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimal station costs and outsourced handling</td>
<td>-7</td>
<td>66</td>
</tr>
<tr>
<td>No free in flight catering, fewer passenger services</td>
<td>-5</td>
<td>61</td>
</tr>
<tr>
<td>Differences in distribution:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No agents or GDS commissions</td>
<td>-6</td>
<td>55</td>
</tr>
<tr>
<td>Reduced sales/ reservation costs</td>
<td>-3</td>
<td>52</td>
</tr>
<tr>
<td>Other advantages:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Smaller administration and fewer staff/offices</td>
<td>-3</td>
<td>49</td>
</tr>
</tbody>
</table>

**Low-cost compared to network carrier**

Now that this essay has established what budget airlines are and how they operate, it will briefly examine their origins in Europe.
3.0 Origins of Budget Airlines

The first budget airline is said to be Pacific Southwest airlines in the United States in 1949\textsuperscript{2}, but one of the earliest and most successful examples is Southwest airlines which began operations in the early 1970’s. Unlike the US, deregulation in the European aviation industry took much longer to come. The European aviation industry has historically been one of the most regulated industries, and state owned airlines were fiercely protected. This section will briefly examine the change in policy in Europe which facilitated the creation of competitive markets and the hence the entrance of budget airlines to better understand how profitability in the industry can be explained.

The first budget airline in Europe was Ryanair, which is headquartered in Dublin and began operations in 1985. It faced great trouble beginning operations and in attaining airport rights, from protective governments, and hence its operations were limited to between Ireland and England. The Third Aviation Package took a great stride towards liberalization in Europe which was introduced on January 1, 1993. This allowed open and unrestricted market access to any routes within the European Union for airlines from any member state and removed all capacity, price controls and artificial trade barriers.\textsuperscript{3} Airlines such as Ryanair, could operate anywhere in the EU and did not have to be dependent on whimsical minister’s decisions. This led to the emergence of budget airlines such as EasyJet, which was formed in 1995. Ryanair and EasyJet were thus the first major budget airlines to exist in a deregulated market.

\textsuperscript{2} US Airways : US Airways a Heritage Story (http://www.usairways.com/awa/content/aboutus/pressroom/history/psa.aspx)
\textsuperscript{3} Doganis pg 46
Deregulation further received a fillip through a landmark decision in the form of the European Court of Justice’s decision in November 2002 to declare that allowing only nationally owned airlines to fly outside the EU from that country was illegal. This meant that Ryanair, an Irish based company, could now fly from Paris to a city outside the EU, such as Moscow. The addition of ten new member states to the European Union in May 2004, further led to the expansion of this free market. A European Common Aviation was now been created, with an open sky regime over 28 countries. SkyEurope, which began operations in 2002 based in Slovakia, could now compete with other EU carriers in this giant Common Aviation Area. Attempts are also being made to bring the five Balkan countries into this zone and sign Euro-Mediterranean Aviation Agreements with Lebanon, Jordan and Morocco. The industry was furthered liberalized by prohibiting state aid, except under specific circumstances to make airlines profitable enterprises. The European Commission was allowed to intervene in competition issues and to fine and punish airlines for violating any of its stipulated rules.

Jeffrey Shane, the Under Secretary for Policy, in the U.S. Department of Transportation, claimed in 1992 that “nothing like the system of government imposed impediments to economic decision making exists in any other sector of international trade.” With this liberalization policy, the Europe Aviation industry has been successfully deregulated. Understanding the history of deregulation and the first mover positions enjoyed by

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4 Ibid pg 50
5 Ibid pg 27
Ryanair and EasyJet lay the framework for analyzing profitability in the budget airline industry.

4.0 Profitability

The airline industry is not known for being profitable. According to a study conducted by Boeing in 1992, the airline industry achieved a 5% operating margin only once, in 1988, during the last twenty years, and it underwent losses for 5 years in the same time period. This is largely because yields have not been high enough to cover unit costs. Analyst Edmund Greenslet showed that the 1991 aviation crisis was caused by costs increasing faster than yields. Some analysts believe that the airline industry is doomed to cutthroat competition and will never be profitable. This is because the short run marginal cost of air transportation is low and is lower than the short run average costs; competition will equate fares to short run marginal costs in the long run rendering airlines to be unprofitable.

Morrison and Winston studied individual airline rate of return determinants in the late 1980’s order to study how some airlines performed better in times of lower economic growth than other airlines. This study was conducted from 1970 to 1988. The study applied the framework commonly used to measure performance in the railroad industry. The approach was to estimate a structural model of a carrier’s rate of return and apply the

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characteristics of more profitable carriers to less profitable ones. The important results of their study, that are significant to this paper, are summarized in the table below.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>P value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average fare (cents per mile)</td>
<td>0.0637</td>
<td>0.0182</td>
</tr>
<tr>
<td>Average compensation (thousand dollars per employee)</td>
<td>-0.0070</td>
<td>0.0031</td>
</tr>
<tr>
<td>Fuel Price (dollars per gallon)</td>
<td>-0.2661</td>
<td>0.1047</td>
</tr>
<tr>
<td>Maintenance expense (millions of dollar per aircraft)</td>
<td>-0.0550</td>
<td>0.0296</td>
</tr>
<tr>
<td>Share of total enplanements at hub airport (percent)</td>
<td>0.0013</td>
<td>0.0030</td>
</tr>
<tr>
<td>Average length of hauls (thousands of miles)</td>
<td>0.3119</td>
<td>0.1502</td>
</tr>
<tr>
<td>Average load factor (percent)</td>
<td>0.0147</td>
<td>0.0047</td>
</tr>
<tr>
<td>Route density (passenger miles divided by route miles)</td>
<td>0.0037</td>
<td>0.0026</td>
</tr>
<tr>
<td>President’s total years with the airline</td>
<td>0.0043</td>
<td>0.0016</td>
</tr>
<tr>
<td>President’s total years of work experience in the airline industry</td>
<td>0.0063</td>
<td>0.0033</td>
</tr>
<tr>
<td>President’s education dummy (1 if president obtained a business degree, 0 otherwise)</td>
<td>0.0408</td>
<td>0.0236</td>
</tr>
<tr>
<td>Vice president’s total years with the airline</td>
<td>0.0017</td>
<td>0.0009</td>
</tr>
<tr>
<td>Vice president’s education dummy (1 if vice President obtained a business or law degree, 0 otherwise)</td>
<td>0.0372</td>
<td>0.0244</td>
</tr>
</tbody>
</table>

The study indicates that increasing load factors, route densities and haul lengths all have positive effects on the rates of return. However, variables that relate to size such as

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8 Ibid pg 97
number of cities served and total departures are statistically insignificant and are not included here.

5.0 Profitability of the European Budget Aviation Industry

This study will calculate profit as the difference between operating revenue and operating costs. It will also use profit rate as a key measure of profitability, which is defined as operating profit divided by operating revenue. What factors make airlines profitable? Why are some airlines profitable while others are not? How should airlines operate to maximize their profitability as well as maintain their competitive advantage in the long run? What techniques should an airline use to increase profits? Some methods that intuitively seem to the best ways to raise profits are not actually so, such as raising ticket prices. If an airline had a monopoly over a route and demand was inelastic, raising the cost of travel would increase revenue. But since competition is plentiful; both from other airlines and from cars, ferries, buses and trains, and the elasticity of demand is difficult to know on many routes, expensive ticket prices are probably not the best profitability technique. This essay will identify variables that it believes are key to profitability and will then use the financial performance of these three airlines to ascertain these hypotheses.

The first determinant of profitability is an airline’s size, scale and reach of operations. This can be measured through the number of passengers carried, the number of routes operated and the size of an airline’s fleet. A larger number of planes facilitates the creation of economies of scale, lowers the effect of maintenance on the airlines
operations and allow more frequent flights between destinations. A greater number of routes reduce the effect on the airline’s poor performance on one route. An additional number of routes also mean that competition is likely to be minimal on several routes, as the network of budget airlines has not been fully developed and this would allow an airline to dominate competition on these routes. Over 30 start-up low cost airlines emerged between 2001 and 2004 in Europe. Debonair, Color Air, Duo and Volare are examples of failed budget airlines, and a majority of them failed because they were too small to compete with existing players. Color Air, for an example, was a 5 fleet Norwegian budget airline that aimed to compete with the established SAS and Braathens. The established airlines responded by slashing fares which caused Color Air to file for bankruptcy.  

The second determinant of profitability is the route length. The unit costs of longer flights are lower than those of shorter flights for several reasons. Several of the miscellaneous costs such as baggage handling charges and ground staff charges are the same regardless of the length of the flight. Fuel consumption is heavy during take-off and landing which increases the average amount of fuel per mile. Additionally, the elasticity of demand is higher for shorter flights since alternative means of transportation are practical for shorter distances, which force airlines to lower ticket prices.  

James Miller III and Leroy Laney of the Council of Economic Advisors performed a regression analysis which estimated fares as a fixed charge plus a mileage charge (F= 10.755 + 0.111 M) indicating that the fares per mile

9 Doganis pg 269
10 O’ Connor William, An Introduction to Airline Economics (Praeger, 1995, Connecticut) pg 72
decrease as length increases, which in turn reflect that the unit cost of a long haul flight is lower than that of a short haul one.\textsuperscript{11}

The third major determinant of profitability is an earlier date of establishment or the first mover advantage. For instance, Ryanair’s, (the first budget airline in Europe), strategy involves entering under-served markets or routes on which they have no air services before. This involves flying to smaller regional airports that are extremely keen for international flights and hence offer major concessions on landing and handling fees.\textsuperscript{12} These discounts give it huge advantages over later players who have to pay full pays or even premiums for services such as landing rights.

The fourth major determinant of profitability is the quality of management. The importance of management in following a plan and distinguishing the airline from competition cannot be overstated. Pierre Condom, in his study of the US aviation industry, believes that industry management has not been proactive enough. Costs controls are ignored in an attempt to gain market share in times of growth, and reactions are delayed in difficult times. In a free market, stronger airlines can force weaker ones out of the game and thereby consolidate their own positions, which is what happened in the United States leading to the strengthening of American, United and Delta.\textsuperscript{13}

\textsuperscript{11} Mac Avoy Paul and Snow John, \textit{Regulation of Passenger Fares and Competition among the Airlines} (AEIPPR, 1977, Washington DC) pg 72
\textsuperscript{12} Doganis pg 169
\textsuperscript{13} Condom pg 26-7
The fifth major determinant of profitability is the load factor of an airline, which is the number of its seats that are occupied. The higher the load factor the more likely an airline is to be profitable since the marginal cost of filling an empty seat on a plane is close to zero.

The sixth major determinant of profitability is an airline’s ability to generate ancillary revenue. With increasing competition in the industry that has led to lower fares and profit margins, additional sources of revenue are essential for an airline to be profitable.

The seventh major determinant of profitability is the airline’s ability to minimize labor costs. Deregulation has benefited low cost carriers as airline worker’s relative wages have declined by about 10% in the US since 1980 because of deregulation. Wages declined by about as much for specialized occupations like pilots and flight attendants, as well as for managers and secretaries.\footnote{Card David, \textit{Deregulation and Labor Earnings in the Airline Industry} (National Bureau of Economic Research, 1996, Cambridge, MA)} It is erroneous to suppose that airlines based in countries with lower wages have lower labor costs; a lot depends on an airline’s organization and management. Latin American carriers have costs averaging about 25% higher than their U.S competitors even though wages are much lower mainly due to the more inefficient use of labor. A 1988 study by the International Labor Organization comparing North American airlines with European, Asian, African and South American airlines found that North American airlines have the lowest ratio of labor costs to operating revenues, showing that they generate the most revenue per unit cost of labor.\footnote{O’ Connor pg 75} Between 1970 and 1990 in the US, passenger miles grew by nearly 250% while total airline employment...
rose by about 84% a remarkable increase in output per employee due to deregulation, better airplanes and more efficient management. Employees have been motivated by granting them stock in return for wage and work concessions. This concept was introduced in the early 1980’s by Eastern, Pan-American, Republic and Western and by 1993 most major American airlines were interested in the scheme. How do airlines minimize labor costs? By minimizing wages and benefits, keeping staff numbers minimum, increasing employee productivity, renegotiating wage levels and conditions of employment, getting airlines to set up low cost subsidiaries, franchising certain routes to cheaper independent airlines and relocating jobs. Airlines can deal with unions by suppressing them by voicing strong opposition and attempting to prevent unions from being established. Alternatively, airlines can fund unions well and attempt to increase worker morale and productivity.

The eight major determinant of profitability is for an airline to minimize fuel costs. Since the cost of fuel is largely dependent on the price of oil, how can an airline optimize its expenditure on fuel? Steps include purchasing more fuel-efficient aircrafts, buying forward contracts, putting more efficient engines on existing aircrafts, reducing short haul flights and increasing load factors.

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16 Ibid pg 85  
17 Doganis pg 136-42  
18 Bamber J. Greg, Gittell Hoffer Jody, Kochan A Thomas and Von Nordenflycht Andrew, *Up in the Air: How Airlines can Improve Performance by Engaging their Employees* (Cornell, 2009, USA) pg 12  
19 O’ Connor pg 78
The last major determinant of profitability is to minimize miscellaneous costs through buying aircrafts in bulk, outsourcing maintenance costs, and availing of airport fee discounts. Many of these measures are dependent on the size of operations.

6.0 Data Source
The data has been obtained from the annual reports of the three airlines. The data is from 2000 to 2008 for EasyJet and Ryanair and 2005 to 2008 for SkyEurope, and is attached as an Appendix.

7.0 Data Analysis
7.1 Introduction
Ryanair, EasyJet and SkyEurope are three of Europe’s best-known low cost carriers. This essay will quickly introduce some of the operating strategies of these airlines that will give help to understand the rationale behind their performance.

Ryanair’s business model is to fly within Europe to obscure airports at very low fares and create markets. According to the CEO, Michael O’Leary, “we’re the airline that will fly to places you didn’t even know you wanted to go.” Ryanair can make its planes land, offload its passengers and turnaround within 25 minutes. 20 Ryanair adopted Southwest’s strategy of picking city pairs that have high potential volume and serving these cities with low fare flights that run at high frequencies. This would allow them to dominate all competition on a route-to-route basis. 21 EasyJet claims its business model is based on six key strengths. A simple fare structure, low unit costs, strong branding, commitment to

20 Foley Stephen, Ryanair find secret to growth (http://www.independent.co.uk/news/business/comment/ryanair-finds-secret-of-growth-615996.html)
21 Bamber J. Greg, Gittell Hoffer Jody, Kochan A Thomas and Von Nordenflycht Andrew pg 100
customer service, a multi based network (dense point-to-point services) and a strong corporate culture. EasyJet also followed a similar operating strategy and aimed at quick turnarounds and high employee productivity, with an important difference of also targeting business travelers. EasyJet flies to main airports unlike Ryanair, and charges fares that are on average 50% higher. Mike Campbell, EasyJet’s director of people, ‘our turnaround period at the gate is twenty minutes.’ EasyJet also seeks to differentiate itself on the quality of its service. Campbell says, “We are low, low cost… (But) we also want to be known for our operational excellence- out on time performance must be the best in the world. We wills continually drive down cost per seat and (increase) our profit per seat. (Overall), our customer proposition is low cost with care and convenience.”

SkyEurope, a relatively entrant had initially tried to position itself as a budget airline for everyone, but later remodeled itself by focusing on a few key routes in Eastern Europe and tried to establish itself as the leading low cost carrier in these markets.

7.2 Profits

Analyzing the financial performance of Ryanair, EasyJet and SkyEurope will help determine the factors influencing their profitability.

Ryanair consistently has had the largest operating profits out of the three airlines, where as SkyEurope made losses every year. Ryanair and EasyJet’s profits substantially increase from 2000 onwards, although EasyJet sees a major fall in profits from 2007 to 2008. Nominal profits increase every year for Ryanair, with the exception

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22 EasyJet Annual Report 2000 pg 2
23 Ibid pg 110
of a 4.6% decrease from 2003 to 2004, which indicate that the growth has occurred in more deliberate manner than that of the other two airlines. The rate of change of nominal profits is the most volatile for SkyEurope, ranging from an increase of 62.3% from 2006 to 2007 to a decrease of a 168% from 2007 to 2008. The scale of operations, however, may influence profits in nominal terms.
Since the scale of operations influences nominal profits, profit rate is a better measure of profitability. **Ryanair has significantly higher profit rates than EasyJet throughout, which has significantly higher profit rates than SkyEurope.** Ryanair’s profit rate increases from 2000 to 2003 reaching its peak of 31.27% in 2003 and then generally decreases until it reaches 20.19% in 2008. EasyJet’s profit rate does not exhibit as clear of a trend. Profit rates are above 10% until 2002, but they decline in 2003. After stagnating for a few years, they recover and reach close to 10% in 2007 before declining again in 2008. SkyEurope’s profit rate is almost identical in 2005 and 2006 with a loss of around 30%. It falls to its lowest level of a loss of 8.9% in 2007 before falling below 20% in 2008.

![Graph showing profit rate for Ryanair, EasyJet, and SkyEurope from 2000 to 2008.]

**7.3 Revenue**

To better understand the reasons for these profits, it is necessary to separately examine its two main components, which are costs and revenues. This essay will begin by examining
operating revenue, which consists of two subcomponents, scheduled revenue and ancillary revenue. Operating revenue increased for all airlines. Ryanair saw a seven-fold increase of revenue from 370.1 million Euros in 2000 to 2,713.8 million Euros in 2008. The rate of increase of operating revenue was consistent for Ryanair increasing by around 20 to 35% every year, indicating that management has been relatively successful in implementing planned growth. EasyJet saw revenue increase by close to seven fold as well from 432.5 million Euros in 2000 to 2,896.8 million Euros in 2008 although growth was more volatile and was characterized by higher growth until 2003, and slower growth from 2003 onwards. SkyEurope saw revenue increase from 112.7 million Euros in 2000 to 260.93 million Euros in 2008, but the growth of operating revenue declined from 2006 to 2008 for SkyEurope. The growth of SkyEurope has been completely organic, where as Ryanair and EasyJet have seen growth through acquisition. Ryanair acquired Buzz on April 10, 2003. The low acquisition price of 20.1 million Euros was largely due to Buzz’s inefficient structuring and management. In 2007, 29.44% of Aer Lingus was purchased at a cost of 392 million Euros by Ryanair and an attempt was made to purchase the entire airline in keeping with a growing trend of consolidation in the European aviation market. This would create one strong Irish airline that could compete with other national mega carriers such as Lufthansa and KLM. This attempt was blocked by the European Commission, and was appealed in court by Ryanair. On July 31st, 2002, EasyJet acquired Go Fly for 374 million Pounds to become Europe’s largest low cost carrier.

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24 Ryanair Annual Report 2003 pg 8
25 Ryanair Annual Report 2007 pg 4
Both airlines were built on common business models with complementary route networks.\textsuperscript{26}

These figures again emphasize that Ryanair and EasyJet are substantially larger airlines than SkyEurope. While Ryanair has higher operating profits and profit rates, it is worth noting that EasyJet has larger operating revenue.

![Graph showing % Change in Operating Revenue]

To understand the reasons for revenues increasing, this essay will examine the performance of the two subcomponents of revenue, scheduled revenue and ancillary revenue.

7.4 Scheduled Revenue

Scheduled revenue is revenue from the sale of tickets, which is dependent on the number of passengers and the average cost of each ticket. As operating revenue has increased consistently, scheduled revenue, its main component, would have to have increased as

\textsuperscript{26} EasyJet Annual Report 2001 pg 2
well. Ryanair’s scheduled Revenue increased from 330.6 million Euros in 2000 to 2,225.7 million Euros in 2008, EasyJet’s scheduled revenue has increased from 836.9 million Euros in 2002 to 2,446.7 million Euros in 2008, and SkyEurope showed an increase from 83.9 million Euros in 2005 to 218.1 million Euros in 2008. Ryanair’s growth has been consistent, while Ryanair and SkyEurope’s growth has shown a downward trend.

This increase in scheduled revenue was caused by the addition of more passengers rather than fare increases for both Ryanair and EasyJet. SkyEurope does not release data on historical average fares, but by examining the growth rate in passengers and the growth rate in revenue, we can conclude that its increase was largely due to an increase in the number of passengers traveled as well.
The fare increase for Ryanair and EasyJet has been minimal. The average fare for a Ryanair flight was 35.74 Euros in 2000 and 44 Euros in 2008. Apart from a substantial fare increase from 2001 to 2002, where fares reached their peak, fares have been relatively stable. From 2000 to 2008, fares have only increased 23.11% totally or at an average of 2.89% per year. The average fare for an EasyJet flight increased from 62.50 Euros in 2003 to 63.82 Euros in 2007 with marginally higher fares being observed in 2004 and 2006. Overall this was an increase of 0.92% and hence is not the explanation for rising revenues. Both airlines’ marketing strategy involves selling the cheapest advertised fares when booking for flights open and then move to progressively higher fares as departure dates approach or earlier sales exceed planned levels. If sales are slow, fares decrease closer to the departure date.²⁷ It is important to note that Ryanair has substantially lower fares that EasyJet. Ryanair is committed to offering passengers the lowest fares possible. In 2007, it launched the “lowest price” guarantee, which promises double the difference to any passenger who can find a lower fare from a

²⁷ Doganis pg 182
competitor on a Ryanair city pair.\textsuperscript{28} This appears to have worked wonders for Ryanair; it became the world’s largest carrier of international passengers as ranked by IATA in 2008.\textsuperscript{29}

Ryanair has recorded the greatest growth of passengers from 2000 to 2008 followed by EasyJet and then followed by SkyEurope. All airlines saw the growth rate of passengers decrease over this period. The passengers carried by Ryanair have increased by 811\% from 5.6 million to 51 million, ranging from around 20 to 50\% every year. The number of passengers carried by EasyJet increased from 5.63 million in 2000 to 43.7 million in 2008, an increase of 676\%. The percentage increase in passengers rose rapidly from 2000-1 to 2001-2 to 2002-3 and high levels of growth were achieved in all three years. Passengers grew by almost 80\% from 2002 to 2003. The rate of increase rapidly slowed down after this falling to an increase of about 20\% in 2003-4 and to 12.7\% in 2006-7 before increasing by 17.55 from 2007-8. SkyEurope’s increase in passengers has slowed down every year changing from an increase of 48.2\% from 2005 to 2006, to an increase of 12.25 from 2007 to 2008. However, total passengers increased by 118\% from 2005 to 2008, increasing from 1.728 million to 3.761 million. This slowdown of passenger growth is responsible for the decrease in the growth of scheduled revenue.

\textsuperscript{28} Ryanair annual report 2007 pg 5
\textsuperscript{29} Ryanair annual report 2008 pg 9
2000 to 2008 saw rapid expansions by Ryanair and EasyJet and a not so rapid expansion by SkyEurope, even though its scheduled revenue and number of passengers has still substantially increased. This gives credence to the theory that expansion and a large size are reasons for Ryanair and EasyJet’s profitability.

The number of aircrafts owned or leased by Ryanair increased from 26 in 2000 to 163 in 2008; EasyJet increased the number of aircrafts it operated from 19 in 2000 to 161 in 2008, but the number of aircrafts operated by SkyEurope only increased from 13 to 15. Similarly, the number of routes operated by Ryanair increased from 28 to 280 from 2000 to 2008 and the number operated by EasyJet increased from 125 in 2003 to 615 in 2008. However, the number of routes operated by SkyEurope only increased from 64 to 76 from 2005 to 2008.
The load factor of a flight is the percentage of seats that are occupied. The rapid expansion by Ryanair and EasyJet was not at the cost of their load factor. Both Ryanair and EasyJet’s load factors have consistently been between 81 and 86%, where as SkyEurope has seen its load factor vary from 73 to 78% except for 2007 where it reached 82.8%, which was the year where its losses were the lowest. Load factor is obviously a
major determinant of profitability since the marginal cost of filling an empty seat is close to zero. It can be compared to the occupancy rate of a hotel.

7.5 Ancillary Revenue

This essay will now examine the second source of revenue, ancillary revenue, which is revenue that supplements revenue from ticket sales, such as sales on board and checked in baggage fees. Apart from an anomalous year for SkyEurope in 2005 and 2008, where EasyJet’s ancillary revenue per passenger has overtaken Ryanair’s, Ryanair’s ancillary revenue per passenger is consistently the highest, giving us another indication why it is the most profitable airline. The share of ancillary revenue in total revenues shows an upward trend for all three airlines, indicating that airlines are attempting to make up for a slowdown in passenger growth through ancillary revenue. Once again, this share is consistently the highest for Ryanair.

Ryanair’s ancillary revenue increases from 39.6 million Euros in 2000 to 488.1 million Euros in 2008; EasyJet’s increases from 40.5 million Euros in 2002 to 450.06 million Euros in 2008 and SkyEurope’s decreases from 27.5 million Euros in 2005 to 10.9 million Euros in 2006. This substantial drop in ancillary revenue caused SkyEurope also expanded its range of ancillary services to a larger selection of on-board sales, pay for use airport lounges and airplane seating and a fee for a no weight limit on carry on luggage, which raised it to 24.971 million Euros in 2008.  

30 SkyEurope Annual Report 2006 pg 13
The ancillary revenue per passenger is an indication of how successful each airline’s ancillary revenue policy has been.
7.6 Total Operating Expenses

After analyzing revenues, this essay will now examine operating expenses. Total Operating Expenses (TOE) have increased rapidly as all three airlines have grown. Ryanair’s TOE has increased over seven fold from 286.1 million Euros in 2000 to 2166 million Euros in 2008 at increases between 20% and 40% every year. EasyJet’s TOE has increased over seven fold as well from 385.5 million Euros in 2000 to 2785.2 million Euros in 2008, but growth has been more volatile. Growth was rapid until 2003 and then sharply declined. SkyEurope has seen expenses increases from 146.2 million Euros in 2005 to 282.4 million Euros in 2008, although after very large increases in operating expenditures in 2005-6, the rate of increase decreased to single digits for the next two years.
This essay will divide costs into three categories: staff, fuel and miscellaneous costs.

7.7 Staff Costs

The number of staff employed by Ryanair has increased from 1232 in 2000 to 5262 in 2008, and those employed by EasyJet has increased from 1140 in 2000 to 6107 in 2008, whereas SkyEurope’s employees have increased from 714 in 2005 to 697 in 2008. The methods use to optimize staff expenditure vary amongst airlines.

Ryanair initially gave workers shares in the company on the condition that they would not join unions, but would get to influence the company’s decisions. Some early attempts at unionization were dealt with by firing those involved. Pilots were made to accept wage reductions and relocate. Many pilots were represented by the Irish Airline Pilots Association (IALPA) who objected to this. Ryanair responded by hiring pilots from the
Romanian state airline, and threatened to fire any dissident pilots.\textsuperscript{31} In contrast to Southwest Airlines’ (one of the airlines Ryanair modeled itself on) focus on balancing work with relaxation, Ryanair made its employees work long hours. One former employee said it was “like being on a treadmill constantly moving at a frenetic pace. Ryanair felt that it owned you. You were hands on all the time but there was no direction.” Reservations staff worked from eight until eight every day including weekends. Cabin crew could work 27 days in a row without a day off.’ To compensate employee for their hard work and to keep unions out, Ryanair compensated its employees well and offered stock option to various groups representing employees.\textsuperscript{32} Ryanair aggressively used pressure tactics and lawsuits to keep out unions.

EasyJet strongly focused on performance measurement and paid wages based on performance. Campbell said that “flight attendants get 50 percent in base pay, 38 percent based on sectors that they fly, an 8 to 9 percent commission for sales on board and a further 3 to 4 percent if the company hits its profit target... Pilots get 80 percent in base pay, 5 to 10 percent based on the length of services, 5 percent based on the sectors they fly and a 4 to 10 percent bonus based on the company’s performance.\textsuperscript{33} EasyJet could offer job security and opportunities for promotion... EasyJet is highly unionized with different unions representing flight attendants, call center employees and pilots. However, a 2002 survey of unionized pilots found that EasyJet pilots were the least satisfied of all pilots in the United Kingdom.\textsuperscript{34} SkyEurope based operations in Bratislava in order to

\textsuperscript{31} Bamber J. Greg, Gittell Hoffer Jody, Kochan A Thomas and Von Nordenflycht Andrew, pg 96
\textsuperscript{32} Ibid pg 97
\textsuperscript{33} Ibid pg 111
\textsuperscript{34} Ibid pg 114
attempt to take advantage of cheaper labor costs. It Implemented a SkyAcademy to provide structured training to develop the management and employees and to increase their value addition in 2007.35

The number of employees per thousand passengers was the least for Ryanair and the greatest for SkyEurope. This ratio declined for all airlines over time suggesting that economies of scale occurred or that operational experience improved efficiency. The staff expenses per passenger were the lowest for Ryanair indicating the success of its employee operational model. Since staff expenses per passenger are about the same for EasyJet and SkyEurope, while SkyEurope has more employees per passenger it indicates that SkyEurope has benefited from lower wage costs in Eastern Europe.

35 SkyEurope Annual Report 2007 pg 21
7.8 Fuel Costs

Fuel Expenditure is heavily dependent on the price of oil. Oil prices have rapidly increased from 2003 onwards and this rate of increase is especially great from 2007 to 2008. Airlines have responded by buying future contracts of oil in order to attempt to save money if they anticipate a price rise and to prevent budgeting uncertainties. Ryanair’s fuel hedging policy is to hedge between 70 and 90% of requirements.  

However, rising oil prices are out of the airlines control. Fuel accounted for 40% of Ryanair’s total operating costs in 2007 and significantly altered the costs structure leading to unit costs rising by 9%. EasyJet initially adopted a no hedging policy because of the expensive cost of hedging and the time lag between the forward contract and the purchase of fuel. The policy was reversed in 2001 and 90% of fuel was hedged. However, it was affected by rising fuel prices. Gert Zonnefeld, an analyst at stockbroker Panmure Gordon, said that EasyJet has yield management systems that target a level of

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36 Ryanair Annual Report 2001 pg 10  
37 Ryanair Annual Report 2007 pg 4  
38 EasyJet Annual Report 2000 pg 7  
39 EasyJet Annual Report 2001 pg 11
load factor and the fares are adjusted in order to go there. It would be difficult to see how EasyJet will be able to pass on escalating fuel costs to the customer after summer.

EasyJet has responded by flying planes up to 2% slower on some routes to try to conserve fuel and save hundreds of pounds per flights, which would amount to millions of pounds every month. SkyEurope was no exception to the hedging policy. In the financial year 2006, around 90% of its fuel consumption was hedged at 60.5 a barrel. In 2007, approximately 89% of fuel consumption was hedged at USD 62.3 per barrel, which created positive gains for SkyEurope.

As expected, the fuel expense per passenger is generally the lowest for Ryanair and the highest for SkyEurope. These costs generally follow an upward trend, but the upward slope is not as large as expected indicating the success of fuel hedging policies. The fuel expenses per passenger are almost identical for all three airlines in 2007.

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40 Milmo Dan, EasyJet Reports Demand still Strong (http://www.guardian.co.uk/business/2008/jul/07/easyjetbusiness.theairlineindustry)
41 SkyEurope Financial Report 2006 pg 17
7.9 Miscellaneous Costs

Miscellaneous costs consist of costs other than those on fuel and staff. They include depreciation; maintenance, materials and repairs; marketing and distribution costs, aircraft rentals, route charges, airport and handling charges and other costs. Ryanair saw these costs rise from 195.9 million Euros in 2000 to 1089.5 million Euros in 2008, while EasyJet saw an increase from 270.3 million Euros to 1547.7 million Euros in the same time. SkyEurope saw these costs increase from 91.5 million Euros in 2005 to 153.5 million Euros in 2008. **Ryanair has substantially lower miscellaneous costs than both other airlines and SkyEurope has the highest costs. These lower average costs are due to economies of scale.** EasyJet ordered 120 Airbus’ at a time (for staggered delivery) and is believed to have got a 40 percent discount on each one. In August 2004, EasyJet operated 91 aircrafts and averaged 12 departures per airport served, where as Germanwings with 15 aircrafts achieved an average of only 2.7 departures per city. More
numerous departures from an airport create economies of scale in passenger and aircraft handling and airport charges.\textsuperscript{42}

8.0 Conclusion

Now that the performance of all three airlines has been thoroughly analyzed, this essay will reach conclusions on different profitability determinants in the European budget industry. It will first focus on how costs can be minimized and then on how revenues can be maximized.

Unit staff costs decreased as size increased and were lower for bigger airlines than for smaller airlines. Ryanair has the lowest unit staff costs and its policy of giving employees stock options and discouraging unions have been the most successful policies. SkyEurope had very similar staff expenses per passenger and more employees

\textsuperscript{42} Doganis pg 270
per passengers than EasyJet indicating that it **outsourcing or relocating jobs to country’s with lower labor costs** is an important profitability strategy.

Unit fuel costs have increased for all airlines, but this increase was not as fast as anticipated given the high increases in oil prices. This indicates that **fuel hedging** is a valuable profitability technique. Future contracts could come back to haunt an airline if fuel prices fall, but the definite price they provide makes them important. Another reason for lower than anticipated unit fuel costs is airlines adopting more **fuel-efficient aircrafts**. Given the high rate of aircraft utilization and low turnaround times, investing in these aircrafts is an important profitability technique.

Miscellaneous costs are by far the lowest for Ryanair indicating again the importance of size, as well as Ryanair’s decision to **outsource maintenance to countries with lower labor costs**. Ryanair and EasyJet’s huge difference in unit miscellaneous costs is partly explained by EasyJet’s decision to fly to major airports with significantly higher charges.

**The quality of management and business strategy** is also an extremely important profitability determinant. EasyJet is a very successful airline, with profit margins of over ten percent for several years. But, the reason its profit rate is so far below Ryanair’s is because of the latter’s superb business strategy and management. Ryanair’s performance in every aspect has been phenomenal from is extraordinary low staff to passenger ratio combined with the fewest complaints per passengers, to its meteoric ancillary revenue growth. Above all, it has a business strategy that is unique, appealing and unbeatable-
offering the lowest fares anywhere it flies. It does not make false promise about being convenient and comfortable, but the cheapest tickets guarantee it with success. Its large size and entrenched network now make it near impossible for any competitors to combine its fares with profitability. EasyJet does have a strategy as well- of cheap flights from major airports. However, its service has closer competitors. SkyEurope, in contrast, has not been able to carve out a niche for itself and distinguish itself from competition.

A high load factor and the ability to generate ancillary revenue are also important profitability determinants. Load factor improves profitability for obvious reasons, and ancillary revenue is a necessary tool for airlines to supplement scheduled revenues especially given the recent spurt in competition, falling fares and economic downturn. Ryanair is set to earn 650 million pounds in revenue in 2009 from baggage charges and booking fees. US Airways in set to earn ancillary revenues of $400 million to $500 million from its ancillary revenue program in 2009. Southwest emphasizes that it does not have hidden fees, but earns ancillary revenue from innovative partnerships with car hire companies, hotels, resorts and gift cards- all carefully selected to suit its brand and customer base.43

However, the most important determinants of profitability in the European aviation market are size, scale and the first mover advantage. The lowering unit costs and advantages from economies of scale have been clearly demonstrated. Ryanair and EasyJet have been so successful because they have the first low costs carriers to operate

43 Eye for Travel, Managing ancillary revenue-the key to profitability but what are the risks? (http://www.eyefortravel.com/news/europe/managing-ancillary-revenue-%E2%80%93-key-profitability-what-are-risks)
in most markets and have benefited from concessionary rates and have been able to establish a brand for themselves. They often did not compete with each other, but tried to establish different routes. By the middle of 2002, low cost competitors competed only on 17 routes, compared to 111 destinations with only one budget airline. Seven of Ryanair’s ten destinations from Hahn are not served by Lufthansa.\(^{44}\) It is difficult for a small airline to compete with such established players. In January 2009, SkyEurope it dropped its lease on six planes that left it with just five aircrafts, and saw year on year traffic decline by 23.5 percent. The company is in the middle of a restructuring involving cost cutting, ending unprofitable routes, and targeting business travelers.\(^{45}\) It has entered into negotiations with Flyholding s.p.A, the owner of the low cost Italian airline myair, to form a strategic alliance to share facilities and resources.\(^{46}\) SkyEurope should have expanded aggressively earlier, by entering into such alliances and buying more planes. It is better late than never, but it might to too late for SkyEurope to prevent itself from going the way of Color Air.

\(^{45}\) Cardais Adam, *Budget Airlines Thrive in Central Europe*  
(http://www.businessweek.com/globalbiz/content/feb2009/gb20090220_392476.htm)  
\(^{46}\) Nagpal Sahil, *Low Cost carrier SkyEurope more than doubles annual loss*  
(http://www.topnews.in/lowcost-carrier-skyeurope-more-doubles-annual-loss-293832)
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q) Ryanair Annual Reports (2000-2008)