Delta air lines (a): the low-cost carrier threat assignment

Environment, Air

Delta Air Lines (A): The Low-Cost Carrier Threat Problem: Delta Airlines didn't have a comprehensive response to low-cost carriers across functions. Option: Delta should launch its own low-cost carrier. Problems: Nearly all major airlines had done this unsuccessfully, proved unsustainable over time, never had a high-cost carrier transformed into a low-cost carrier. Since deregulation (1978) the average return on investment below cost of capital for the 5 largest carriers.

Due to 9/11 the demand for air travel declined sharply. • Airline's profitability hinged on the fraction of its flown seats occupied by passengers-load factor • Costs measured in cost per available seat mile (CASM) – cost required to fly one seat one mile • Yield- total passenger revenue/number of revenue passenger miles (RPM) • RPM- number of revenue seats times the number of miles flown • Average stage length-flight distance • Marginal cost to add a passenger is negligible • Turn-time of the plane is important Cost per available seat mile was low for airlines that flew long distances • After deregulation- high fixed costs and expensive labor, in need of systems to ensure high load factor • Shift to hub and spoke model- which helped achieve high load factor and market power • Segmented into major, national, and regional carriers • Price was the overriding concern of 1/3 of passengers • Airlines encouraged loyalty by frequent flier programs, differentiation of service? , frequent departures, and a distinctive culture. Business travelers less sensitive to price- concerned most with schedule • The rise of the internet made customers more aware of price • Yield Management- the computer system became a powerful tool for " adjustable rate airfares" • The internet placed increasing pressure on the airlines • The

Air Transportation Safety and System Stabilization Act- attempted to compensate airlines for losses incurred due to attacks Total Cost 40% employee salaries and benefits –largest expense 10-15% Fuel 15-20% Services 15% Aircraft and facility rental

After 2001 only the low cost carriers Southwest, JetBlue, and AirTran remained profitable. Southwest- love theme, prided itself on being different, no meals, no seat assignments, no-frills, enthusiastic work force, price low, load factor high " The Southwest Affect" Imitators had little success- the expanded to quickly, poor decisions regarding route selection, or confronted with fierce competition JetBlue- Successful copycat, low cost, new technology and strong brand, the most highly capitalized start-up, 60% of flights booked on-line, video monitors, leather seats, flexibility among employees, " paperless airplane". cheap chic" image CALite- 1st response to Southwest, tried to schedule passengers on a mix of CALite and mainline flights, people went entire days without meals Others: Shuttle by United, Metro Jet by US Airways " Subsidiaries don't work- they are not truly low cost" Delta • After merger with Western Airlines, 1987, they were the 3rd largest domestic passenger carrier • After deregulation they were the most profitable airline • Only the pilots were unionized- productivity advantage 3 threats: 1) Mainland hub and spoke carriers had been dropping fares) Regional airlines were eating away at Delta's traffic 3) LCC's had made significant inroads into Delta's Florida market Result: Delta Express- low fare subsidiary that served Florida, it had separate gates, flight attendants in casual attire, and specially painted aircrafts, lower labor rates, higher aircraft utilization The decisions concerning routing, flight frequency, and pricing were made centrally and maintenance, pilots, flight attendants, and ground services were shared. 1. Despite the challenging industry environment, airline like Southwest Airlines and JetBlue earn superior returns, How?

Cost advantage and differentiation strategy Southwest limit itself to a 10%-15% growth, differentiated strategy (love theme), simple operation (all-Boeing 737 fleet, no meals and seat assignment, no frills, flexible work rules, enthusiastic workforce, high aircraft utilization), good relationship with employee unions, focus on service, low price (compete with the price of auto travel), high load factor, Simple pricing structure which is transparent to customer. JetBlue Low CASM, high load factor Humanity, good amenities (in-flight entertainment system)

Low costs: simple fare structure New technology: Internet (60% of seats were booked on-line), paperless operation, computerized, Reservation operation (not using call center) Strong brand: “ Cheap chic” image Employees are all nonunion, high “ esprit de corps”, flexible employee package, 2. Why have all of the low-cost subsidiaries of full-service airlines, including Delta Express, failed? The main reason for the low-cost subsidiaries’ failure is the airlines’ corporate strategy. By launching a LCC as a unit inside the same corporate structure (e. . , single scheduling and pricing centre for United Airlines’ and Shuttle’s low–cost flights), traditional airlines limited the LCC’s flexibility and independence. By building a low-cost carrier on top of a traditional carrier cost-structure, the parent company was also tempted to think low-cost when setting ticket prices, but not trying (or being able) to reduce traditionally high costs: the airline had now two unsustainable business models instead of one! Secondly, such a strategy requires an extremely complex cultural change.

Airlines are traditionally highly unionized and have comprehensive compensation plans, which makes it difficult to convince workers to accept lower compensation plans (e. g. , UA’s Shuttle lost its competitive cost structure when had to merge low cost and traditional flights compensation structures due to Union pressure). As a result, attempting to launch an LCC on-top of a traditional airline structure usually entails a very high chance of failure. Finally, low-cost subsidiaries integrated with traditional airlines create misunderstanding for the consumers.

Customers often look at them as low-quality versions of traditional carriers and fail to understand why and to what extent the traditional offer has changed (food, amenities, service quality…), which increases the complexity of choice and the probability of dissatisfaction. This problem can be clearly seen in Continental airline’s LCC CALite: in a multi-leg flight, for instance, if a passenger took low cost flights during the meal times and the legacy during the non-meal times then he would not eat at all. . Based on the information available to you in Case (A), what course of action (response to the low-cost threat) would you recommend to Delta’s board? Delta’s cost structure should be changed to reduce any factor that doesn’t support the new value proposition. Some possible actions are: • Fleet rationalization: reduce the number of airplane models to achieve efficiencies in maintenance and buying. Focus, whenever possible, on models that require lower wages for pilots (e. . , Airbus A320 with similar number of seats to a Boeing 737-800 and pilots’ compensation that is less than half); • Routes evaluation: get rid of non-strategic non profitable routes or consider alliances for those routes where there is excess capacity (code-share); • Wages negotiation: negotiate with unions to reduce labour costs (especially for pilots), show urgency of situation (salaries go down or company goes down);