

Issued: October 10, 2006  
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## **Europe's Top 4 Low Cost Carriers Generated 470 Million Euros (US\$593 Million) From Non-Ticket Sources in 2005**

*But U.S. frequent flier programs produced revenues estimated at 2.5 billion Euros (more than US\$3 billion) and better per passenger results.<sup>1</sup>*

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.<sup>2</sup> 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 (US\$9.77) per passenger, while United's Mileage Plus frequent flier program posted amazing results of €9.40 (US\$11.98) 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 (US\$25 million) during 2005.

An IdeaWorks analysis reveals growing distinctions between the LCC model that is prevalent in the United States and that which is developing throughout the world. LCCs in the United States are realizing attractive revenue streams from the sale of miles or points to program partners. LCCs outside the USA have cultivated a fee-for-service strategy that is designed to maximize the revenue potential of each passenger by charging for services that US-based LCCs normally include in the price of a ticket.

### **Ancillary Revenues Defined**

As is often the case, the airline industry lacks accepted definitions. For example, there is substantial debate on which airlines qualify as LCCs. Perhaps the definition for ancillary revenues will be less elusive. The Random House Unabridged Dictionary defines ancillary as, "subordinate, subsidiary, auxiliary, and assisting." This suggests the revenues should be linked to activities associated with passenger travel.

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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.

IdeaWorks proposes a broader definition to include revenues generated from frequent flier activities. The following definition of ancillary revenue is suggested: **“Revenues beyond the sale of tickets that are generated by direct sales to passengers, or indirectly as a part of the travel experience.”** This definition includes the commissions earned by many airlines on the sale of hotel accommodations, car rentals and travel insurance. IdeaWorks offers the following as examples of ancillary revenue activities that occur in the United States and throughout the world:

<b>Table 1: Examples of Non-Ticket Revenue Sources for Airlines</b>	
<b>Flight Related &amp; Other Ancillary Revenues</b>	<ul style="list-style-type: none"> <li>• Onboard sales of food and beverages</li> <li>• Checking of baggage or excess baggage</li> <li>• Assigned seats or better seats such as aisle rows</li> <li>• Fees charged for purchases made with credit cards</li> <li>• Commissions from the sale of hotel accommodations, car rentals and shuttle bus transfers reserved at the airline web site and,</li> <li>• Commissions from the sale of travel insurance and airport lounge access</li> <li>• Advertising tied to passenger travel such as onboard magazines and in-cabin media.</li> </ul>
<b>Frequent Flier Ancillary Revenues</b>	<ul style="list-style-type: none"> <li>• Miles or points sold to banks issuing co-branded credit cards,</li> <li>• Travel partners such as hotel chains and car rental companies and,</li> <li>• Other partners such as online malls, retailers, and communication services</li> </ul>

**Comparing Ancillary Revenue in Europe and the USA**

Southwest Airlines is widely credited with launching the LCC phenomenon. The airline originally offered a simplified product and charged lower fares than large established airlines. Consumers could opt for lower fares by giving up meal service, advance seat assignment and frequent flier benefits. Over time, the product distinction between Southwest and the established airlines (now called legacy carriers) began to blur.

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Legacy carriers, such as United and American, have cut back on service while Southwest has been adding more frills such as its Rapid Rewards frequent flier program. The prevailing LCC model in the United States now 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.

Ryanair led the development of LCCs in Europe and borrowed Southwest's early model of low fares and no frills. The airline 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. The "Flight Related & Other Ancillary Revenues" described earlier in Table 1 largely defines the source of these ancillary revenues.

This represents a clear distinction from the LCC experience in the United States. While ancillary revenues may become a reported item in the future, the financial statements of U.S. carriers are largely silent on the issue. Some airlines reference "other revenues" but this is often a very broad category that includes maintenance and airport services sold to other airlines, along with excess baggage fees and onboard liquor sales. Separating the true ancillary items is not possible under this type of financial reporting method.

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. LCCs such as JetBlue and Frontier also reported the revenues generated by frequent flier programs. The "Frequent Flier Ancillary Revenues" described earlier in Table 1 largely defines the source of these revenues.

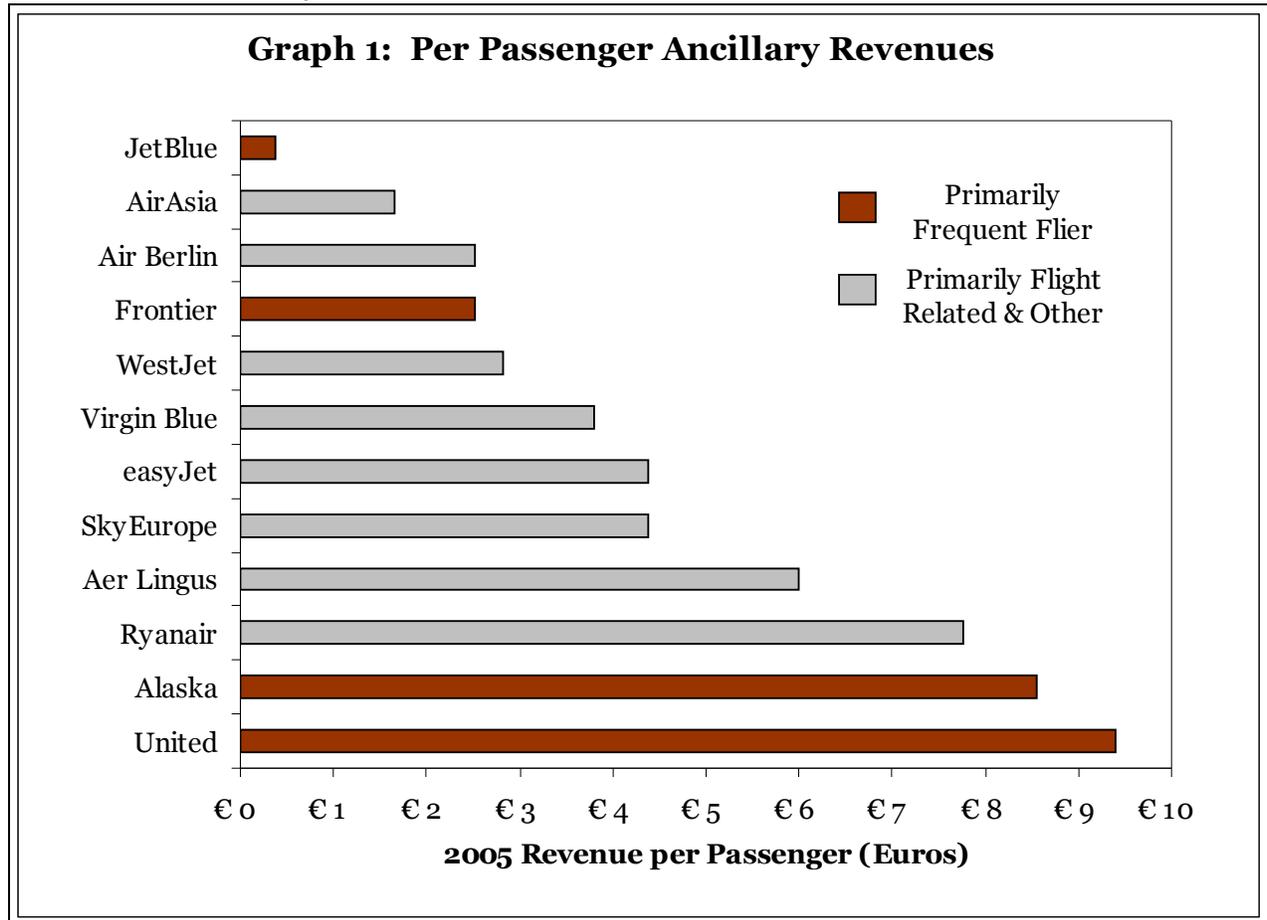
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### Ancillary Revenues for Select Airlines

IdeaWorks retrieved ancillary revenue data from established LCCs in Europe, Asia and the United States. The results are presented below in Graph 1. Alaska and United were included as representative of the results generated by major U.S. airlines. They were also among the few U.S. major airlines to report the revenues generated by their frequent flier programs.

The complete range of ancillary revenues realized by U.S. airlines is likely to be higher than those reported in Graph 1. As described earlier, the results reported for these airlines do not distinctly define revenues generated from traditional sources such as onboard liquor sales and excess baggage charges. Graph 1 notes the distinction between the source of ancillary revenues for US-based and non-US airlines.



Caution is advised when comparing the results across regions of the world, such as Asia, where average fares and costs overall are lower than in Europe and the United States. Results are also impacted by fluctuations in exchange rates. Please refer to the footnotes include in Table 2 for details about the information presented in the graph.

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United and Alaska financially benefit from the maturity of their frequent flier programs which boast millions of members and well-developed partner networks. They also feature co-branded credit cards that have significantly numbers of active cardholders. On a per passenger basis, the frequent flier programs beat the ancillary revenue activities of Ryanair and easyJet. Table 2 lists specific ancillary revenue amounts (as shown in Graph 1) for each carrier in Euros and U.S. Dollars:

<b>Table 2: Ancillary Revenues for 2005</b>		
Aer Lingus	€ 5.99	\$7.60
Air Berlin	€ 2.51	\$3.16
AirAsia <sup>3</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>4</sup>	€ 4.38	\$5.51
<b>United</b>	<b>€ 9.40</b>	<b>\$11.98</b>
Virgin Blue <sup>5</sup>	€ 3.80	\$4.82
WestJet	€ 2.82	\$3.59

United attributed revenues in excess of €627 million (US\$800 million) to its Mileage Plus frequent flier program for 2005. The ancillary per passenger revenue result of €9.40 (US\$11.98) likely tops all other carriers in the world, with the possible exception of American Airlines. IdeaWorks believes American's AAdvantage program produces greater revenues; American does not release this information to the public. JetBlue is at the other end of the spectrum; its low revenues are consistent with the recent 2005 launch of an American Express co-branded credit card and the program's early results.

Alaska reports its Mileage Plan program generated revenues of €141 million (US\$180 million) during 2005 from the sale of miles to bonus partners. Typically, airlines sell the majority of bonus miles to their credit card partners at an average price of a U.S. penny per mile. IdeaWorks believes more than 70% of the miles earned by Mileage Plan members are now generated by charge activity tied to Alaska's Mileage Plan credit card.<sup>6</sup> This statistic is also believed to apply for the programs operated by the major U.S. airlines. In effect, the credit card banks are paying US\$250 (€198) for each 25,000 mile reward ticket earned through charge card activity.

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#### **Ancillary Revenue Methods Vary**

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 (US\$5.70) per piece, or €10.00 (US\$12.69) 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 (US\$3.17) per passenger per flight. The fee is lower for debit card transactions and is waived for infant travelers.

Virgin Blue of Australia is also creative in its pursuit of ancillary revenues. The airline operates luxurious lounges in Sydney, Brisbane and Melbourne and offers one-day access priced at 30 Australian Dollars (€16.62, US\$22.36), in addition to membership plans. In-flight entertainment is available on its 24-channel "live2air" service for a fee starting at 6 Australian Dollars (€3.52, US\$4.47). Virgin Blue passengers may also pre-reserve an extra roomy exit row or front row seat for 30 Australian Dollars (€16.62, US\$22.36) each way. Virgin Blue recently launched a robust frequent flier program called Velocity. The airline will likely earn attractive ancillary revenues from the sale of points to its hotel chain, car rental, co-branded credit card, and international airline partners.

Air Berlin has quickly become Europe's third largest LCC and has chosen to pick and choose from the Ryanair model. There are no charges for checking a piece of luggage, but seats can be pre-selected for a fee of €8.00 (US\$10.16) per person per flight (no fee is charged for the disabled or families with infants). Seats with more legroom, called XL Seats, cost €20.00 (US\$25.20). Paying by credit card will incur a fee of €6.00 (US\$7.62), but the fee is waived if the consumer uses their Air Berlin MasterCard. Yes, the airline is the largest LCC in Europe to offer a frequent flier program.

The Top Bonus Program is full featured and offers increased sophistication through an elite tier program. Frequent flight activity earns higher elite tier status and more benefits. Alternatively, consumers may simply pay a fee of €50.00 (US\$63.44) per year to immediately enjoy Silver tier benefits. These include free seat selection, greater checked baggage allowance and a 5% discount with Air Berlin's onboard shop.

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Financial documents filed by Air Berlin <sup>7</sup> for their 2005 fiscal year provide a glimpse into the results generated by key ancillary activities:

<b>Table 3: Selected Air Berlin Revenues from 2005 Financial Statements</b>				
<b>Ancillary Activities</b>	<b>€ Revenues</b>	<b>Per Pax.</b>	<b>\$ Revenues</b>	<b>Per Pax.</b>
Onboard Sales	€ 15,000,000	€ 1.11	\$19,043,456	\$1.41
Excess Baggage	€ 5,200,000	€ 0.38	\$6,601,466	\$0.49
Elite Level FFP Benefits	€ 1,800,000	€ 0.13	\$2,285,122	\$0.17
Trip Insurance	€ 1,600,000	€ 0.12	\$2,031,465	\$0.15
Pre-Assigned Seats	€ 1,600,000	€ 0.12	\$2,031,465	\$0.15
In-flight Magazine Advertising	€ 1,500,000	€ 0.11	\$1,904,498	\$0.14

Revenues produced by onboard sales, which includes meals and duty free merchandise, led all categories. Air Berlin's unique offer to allow customers to purchase immediate Silver elite tier benefits was accepted by an estimated 36,000 customers during 2005. Pre-assigned seating was purchased by an estimated 200,000 passengers and represented almost 1.5% of Air Berlin's 2005 passenger enplanements.

### **Observations and Conclusions**

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 (US\$12) 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.

Exceptional financial results are likely to be realized by those airlines that master the magic of combining the best features of the European and U.S. models. These airlines will maximize the potential of generating ancillary revenues from flight related and frequent flier sources.

## **LCC Ancillary Revenues Analysis for LCCs**

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**About IdeaWorks:** IdeaWorks was founded in 1996 as a consulting firm building brands through innovation in product, partnership, and marketing and building profits through financial improvement and restructuring. Its international client list includes the hotel, airline, marine, railroad, consumer products and health care sectors. IdeaWorks specializes in brand development, profit improvement, competitive analysis, creating partner-marketing strategies, cost reduction programs and business restructuring. IdeaWorks brings value as a consultant by researching the expectations of the customer, learning from the wisdom of the client organization and applying innovative ideas to create solutions for clients and consumers. Learn more by visiting: [IdeaWorksCompany.com](http://IdeaWorksCompany.com).

**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.

**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. This Industry Analysis was independently produced and has not been completed as work on behalf of a client company. IdeaWorks cannot guarantee, and assumes no legal liability or responsibility for the accuracy, currency or completeness of the information.

<sup>1</sup> 518 million passengers were carried by U.S. major airlines during 2005. IdeaWorks estimates minimum frequent flier related revenues were US\$6 per passenger.

<sup>2</sup> "A radical fix for airlines: Make flying free" Business 2.0 Magazine, March 31, 2006.

<sup>3</sup> 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.

<sup>4</sup> SkyEurope results are for the 9 month period ended June 2006.

<sup>5</sup> Virgin Blue results are for the fiscal year ended September 2005 and reflect 4.9% of total revenues, as referenced in financial documents.

<sup>6</sup> "Frequent Fliers Reach New Heights with More Than 15 Million Reward Trips During 2005" Issued by IdeaWorks (Page 7) May 22, 2006.

<sup>7</sup> Air Berlin reported total amounts in Euros, and IdeaWorks calculated per passenger revenues based upon the airline's 2005 passenger total of 13,537,000.