REPORT
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MODEL MUDDLE

Many regional airlines face tough choices between independence and integration as the consolidation of major carriers prompts a rethink in business strategy

"The regional airline model is broken," has become a commonly repeated refrain.

Sean Menke, president and chief executive of Pinnacle Airlines said it right before the carrier filed for chapter 11 bankruptcy. Comair president Ryan Gumm said it right before Delta Air Lines shut down his regional airline. Helane Becker, analyst at Dahlman Rose, said it while discussing the problems that US regional airlines are facing.

What all of them are saying is that US regional carriers are too dependent on major airlines and relations between them have reached such a crunch that it is doubtful many regionals will survive.

These are tough times for regionals on both sides of the Atlantic. In the USA, ExpressJet has sold itself to SkyWest Airlines for $50 million less than it was offered in 2008. Delta is closing Comair. Pinnacle, as part of its own bankruptcy reorganisation, is closing Colgan Air. American Eagle expects to be spun off from American Airlines. Smaller carriers face uncertain futures.

If the model for US regional airlines is "one regional bidding against others for a contract to feed traffic to and from a major carrier", then the model, if not broken, has become what one consultant calls "a race to the bottom".

"The large carriers are playing the small ones off by putting segments of the business out for bid, and pretty much accepting the lowest bidder that can do the job," says George Hamlin, president of Hamlin Transportation Consulting. "It's becoming a commodity business with multiple bidders. And the cost pressure on regionals is extreme."

Low-cost carriers are seen as a major culprit on both sides of the Atlantic. Europe's regionals are suffering from the takeover of their routes by carriers such as Ryanair and EasyJet. North American low-cost carriers have had a trickle-down effect. By forcing the majors to cut costs, the majors, in turn, are forcing regionals to cut their costs as well. Such pressures are still at early stages in Asia, Latin America and the Middle East. In Africa, they have hardly begun.

For this reason and others, major differences in regional models persist around the world. The most dramatic difference is in how much traffic is carried by independent regional carriers in different locales.

The term "independent" refers to regional airlines that are neither owned by, nor primarily contracted to, a major. They are free-standing airlines that operate under their own brands with little or no integration with major carriers. The bulk of their traffic is point-to-point, rather than feed traffic to or from another airline.

96%

Amount of North American regional traffic flown by captive or feeder airlines

The presence of independents varies widely around the world. Flightglobal data shows that in Africa and the Middle East, they carry 60% of all regional traffic. In Latin America it is 56%, in Asia-Pacific 42%, and even in Europe 41%. Globally, independents transport a third of all regional traffic.

MUSICAL CHAIRS

By contrast, North America has almost no independent regionals. About 96% of all North American regional traffic is flown by captive or feeder airlines – carriers owned by or flying under contract for a major airline. This makes relations between regionals and majors more adversarial. With the mergers of United-Continental and Delta-Northwest, US regionals are becoming more dependent on fewer contracts. As Hamlin puts it: "With consolidation, we can expect musical chairs

Rex Features

with fewer and fewer players."

A regional's decision to join forces with a major or go it alone can affect its size. Lufthansa Consulting, in a presentation at the Moscow regional airline conference in September 2010, showed how the world's largest regionals are also those with the closest operational ties to a major airline partner. "Financial integration", as Lufthansa Consulting calls it, is far less important than "network integration".

Take for example Jazz Air, which has a capacity purchase agreement with Air Canada, and MASwings, which is wholly owned by Malaysia Airlines. Jazz is many times larger than MASwings because of the size of its market and its deal with Air Canada, even though Air Canada no longer owns Jazz. As Lufthansa Consulting declares: "Regional airlines are dependent on feeder relationships to enable profitable fleet growth above 30 aircraft."

Two major independents, Australia's Rex and the UK's Flybe, show that a well-run independent can support more than 30 aircraft – Rex operates 51 Saab 340s, while Flybe has 83 aircraft comprising Embraer regional jets, Bombardier Q400s and a small number of ATRs. However, Lufthansa Consulting is still right that commercial integration with a major airline drives the size of a regional's fleet.

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But fleet size is only one measurement of a regional's success. In today's market, a more accurate measurement may be how much protection it has from the cost-price squeeze that majors are forcing on so many regionals.

Rex occupies one end of this dependent-independent spectrum. It codeshares with no airline and has no contract to carry traffic for any major. The closest Rex comes to any link with a major airline is its interline agreement with Virgin Australia at three major Australian airports. And that is not very close. Lim Kim Hai, Rex's executive chairman, says interlining with Virgin Australia does not generate much traffic.

INDEPENDENT BENEFITS

"We do not receive much commercial benefit from this," Lim says. "Our booking systems are not aligned so passengers cannot book a through ticket." The main benefit is the ability of passengers to interline baggage, he says. "It's more a convenience to passengers."

Overall, Lim estimates that "around 90% of Rex's traffic is point-to-point". He attributes this to Australia's sparse interior and Rex's hub-and-spoke network. "We bring the outback to the capital cities, and deliver professional services to the outback. A lot of government officials, doctors, and specialists fly in and out of the outback."

Lim recognises that Rex's predecessors – Kendell and Hazelton Airlines – enjoyed more feed. Up to 30% of their traffic was compliments of the now-defunct Ansett Airlines. He also recognises that Rex perhaps could gain more feed by aligning with a major. But he sees risks in doing this, mainly, "when you align with one of the parties, you sometimes become targeted".

Lim cites the experience of Australia's Skywest Airlines. "Only after Skywest Airlines aligned itself with Virgin," Lim recalls, "did Qantas decide to go into some Western Australia routes served by Skywest. It makes me wonder."

Conversely, he sees benefit in regional airlines staying independent: "You probably will not do as well in the short term. In the old days, Kendell had a much higher feed from the main carrier.

"But being all by yourself will force you to be extremely competitive and efficient. It forces you to count on yourself. So you really are going to be a much stronger airline."

After all, he could have added, look what happened to Kendell and Hazelton when Ansett Airlines went bankrupt. Government subsidies propped the carriers up until Rex bought them.

STRATEGY SHIFT

The UK's Flybe started at the same independent end of the scale as Rex, but it is moving away from the pure model. Flybe became Europe's largest independent regional five years ago when it bought the regional arm of British Airways, BAConnect. Flybe has held close ties with Air France for many years (which has included franchise agreements), and has had interline agreements with a number of international airlines.

STEPHEN TRIMBLE WASHINGTON DC

US SECTOR TO EMERGE WITH LEANER NETWORKS AND LARGER JETS

In this *annus horribilis* for the US regional airline sector, the bottom of the market downturn might not have been reached, but is perhaps finally coming into view. The final picture emerging is that of a sector with fewer airlines flying smaller networks with larger jets.

Gone are the days when the regional sector could be relied upon to deliver consistent earnings even when the bottom fell out of the market for large US network carriers. But no other year since the arrival of the regional jet two decades ago has been as painful as 2012.

Delta's wholly-owned subsidiary Comair, which ushered in the revolution of the regional jet in the early 1990s, has disappeared entirely since the beginning of the year. The brand of a second former subsidiary, Atlantic Southeast Airlines, has vanished after it was absorbed into ExpressJet by new parent SkyWest. Republic Airlines has warned that one of its subsidiaries – Chautauqua Airlines – must completely restructure or face oblivion. And finally, Pinnacle Airlines not only filed for bankruptcy and shut down Colgan Air, but has been forced to rip up its first restructuring plan that was focused curiously around 50-seat regional jets.

Most of the carnage was expected in scope if not in detail. It was already clear at the start of the year that the regional sector was in grave financial shape. SkyWest, for instance, reported a net loss for the first time in 23 years, and yet was relatively healthy compared with many of its peers.

The regional jet sector has out-grown the network strategies of its large airline partners.

American Eagle wants to operate larger jets

Bill Abbott

The major network carriers, which mostly use the regional carriers to feed traffic to hubs on short, thin routes, have been focused on shrinking unprofitable domestic routes and growing the most lucrative international markets, especially to Asia and Latin America. The network carriers want their regional carriers to provide less capacity and to operate more efficiently.

Meanwhile, rising fuel prices and maintenance costs have made the ubiquitous and increasingly ageing 50-seat jet challenging to operate profitably, even under the capacity purchase agreements that are the norm in the regional jet sector.

The pieces of a restructured regional sector have started to emerge, albeit in unexpected ways. As the world's largest 50-seat jet operator, SkyWest has been heavily courted by Bombardier and Embraer for replacement orders. But the Utah-based airline disappointed both manufacturers in July, signing an agreement in principle to buy 100 Mitsubishi MRJ regional jets. If the deal is converted to a firm order, SkyWest would become the second US regional carrier after Trans States to order the Japanese airframer's 70- to 90-seat regional jets.

But Bombardier and Embraer still have plenty of opportunities in the US regional jet sector. Much depends, however, on the outcome of the independent American Eagle that emerges following the bankruptcy restructuring of parent AMR. American Eagle has made it clear that it wants to operate 76-seaters, and has listed the Embraer E-Jets, Bombardier CRJ900 and MRJ as candidates in negotiating documents with pilots unions.

Obtaining relief from scope-clause restrictions to operate larger fleets of 76-seat jets is also a priority for the legacy Continental operation. The airframers expect Continental to order a replacement for its 50-seat ERJ-145 jet fleet operated by ExpressJet later this year.

In 2008 it signed a codeshare with BA when it agreed to carry its traffic between London Gatwick and Manchester.

Since then, Flybe has added one major codeshare a year. It was Etihad in 2009, Air France in 2010, a form of contract flying for Finnair in 2011 and KLM this past May. Under each of these, Flybe codeshares with its major partner from the major's hub, carrying passengers to or from regional cities primarily in the UK or, in the case of Finnair, other Scandinavian and Baltic cities.

Flybe took its biggest step last year, when it restructured itself into three divisions, one for the UK, one for Europe and one for aviation support.

Then it formed a joint venture called Flybe Nordic, taking a 60% stake in the venture, with Finnair holding the rest. This venture then bought Finnish Commuter Airlines (Finncomm) and renamed it Flybe Finland. With this move, Flybe became Finland's largest domestic airline and a feeder for Finnair's international flights. The carrier will operate another 12 Embraer 190 regional jets on behalf of Finnair under a contract starting at the end of October.

Clearly, Flybe is moving away from the pure independent model of Rex. By the end of this year, two-thirds of the revenue from its Finland joint venture will come from contract flying. Flybe estimates that 25% of its overall capacity will be deployed under various contract arrangements. This includes two aircraft that it operates for Brussels Airlines, but most of this contract flying is linked to its growing ties with major airlines.

Flybe chief executive Jim French makes no apologies for this strategy shift. With "stubbornly high" fuel prices, the Finland venture is more than compensating for the UK's doldrums. French claims that his carrier's entry into Scandinavia has brought a 20% increase in revenue.

Flybe's experience is noteworthy in several ways. First, 75% of its capacity is still devoted to independent regional transport. Second, Flybe is not putting all its eggs into any one basket. It interlines with many carriers and codeshares, or has other contracts, with no less than five majors. Exclusivity is not on its agenda.

Third, Flybe flies to and from major hubs, but not between them. As everyone in the regional business knows, that can be suicide. Lastly, Flybe and Rex both supplement their regional revenue with related ventures – aviation support, charters, pilot training, air ambulance service, and so forth. As Rex's Lim Kim Hai says: "We are not dependent on this extra 15-17% of revenue, but it's nice to have it."

REGIONAL DIFFERENCES

Dr Andreas Kraus, associate partner at Lufthansa Consulting, sees two major differences between the North American and European regional markets. "If you reflect on the competition game in the aviation industry, North America has been five to 10 years ahead of Europe," he says.

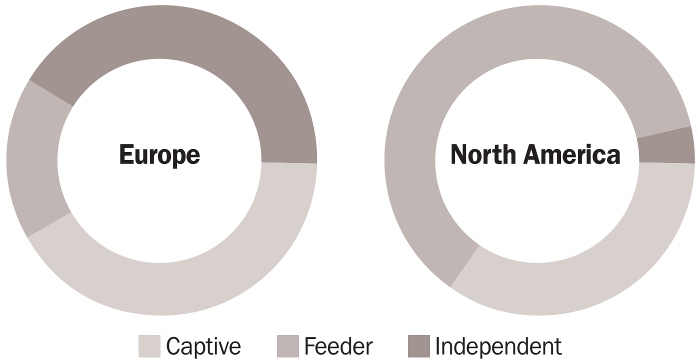
The effects of deregulation have brought changes to North America that Europe is only starting to see. Finnair's decision to outsource regional flying, for example, is a relatively new concept in Europe.

Geographic differences, Kraus says, are also significant. Many more European cities are within the range of regional aircraft than in North America. Hence, European regionals fly more point-to-point routes and rely less on feed traffic with the major airlines. But even in Europe, he warns, "the market niches for independent regional airlines are getting smaller".

Several years ago, ExpressJet came the closest of any recent US regional to copying the Rex/Flybe model – independent branding and marketing, with operations on point-to-point routes. Revenue was good, but rising fuel costs erased all the profit. Perhaps the experiment might have ended on a happier note if ExpressJet had instead been "ExpressTurboprop".

Startup carrier California Pacific now hopes to succeed where ExpressJet failed. It plans to operate point-to-point flights using its own brand within California, and to Las Vegas and Cabo San Lucas, Mexico. It too plans to use regional jets, but will operate larger and more economical 80-seater E-170s. As George Hamlin notes: "Economics make 70- to 90-seats the new minimum."

SHARE OF PASSENGERS CARRIED BY TYPE OF OPERATION IN THE TWO LARGEST REGIONAL AIRLINE MARKETS



SOURCE: *Airline Business* Regional Airlines Survey

"The trend away from ownership and exclusivity is changing relations between majors and regionals"

However, California Pacific does not represent a trend, at least not yet. The cost of keeping regional subsidiaries is forcing North American majors to shed them.

Air Canada's Jazz Air was one of the first regional carriers to go. Since its separation, the airline has continued to act as a feeder for Air Canada. However, this progression is taking another step, with a movement away from exclusivity.

Air Canada's new pilot agreement loosens the scope clause so that Air Canada can now source regional flying from other carriers. As Joseph Randell, chief executive of Jazz's parent, acknowledges: "There is no [more] exclusivity."

This is the trend. Delta has already sold Mesaba and Compass, and is closing Comair. American plans to divest American Eagle, whose pilots are already worried that American will award flights to other regionals. Only Hawaiian and WestJet seem to be bucking this trend. Instead of divesting, for reasons unique to themselves, they plan to launch new regional subsidiaries.

The trend away from ownership and exclusivity is changing relations between majors and regionals. Major carriers want to keep their presence in smaller cities because of the network benefits. They still need regionals to do this.

Will these regionals become franchisees of the majors and give up their own brands as they have in the past? Or will they fly their own liveries, market themselves and become non-exclusive partners, either under codeshares or "enhanced interline" agreements such as those offered by Delta?

As the number of US majors shrinks through consolidation, regionals that survive will continue to face big choices about their business models. ■

Read how Mitsubishi hopes to capture 50% of the 70-100 seat jet market with its MRJ at: **flightglobal.com/mitsubishi**