

# Leap of faith

➔ KLM'S JURRIAN STELDER EXPLAINS THAT, WHILE THEY MUST FOCUS ON SHORT-TERM COSTS, AIRLINES CANNOT NEGLECT LONG-TERM NETWORK DEVELOPMENT STRATEGIES AND RISK BEING AT THE BACK OF THE QUEUE WHEN THE MARKET PICKS UP.

## KEY FACTS

- ➔ The present economic climate is the most difficult time that airlines have gone through over the past 40 years.
- ➔ KLM can remain flexible by operating planes for several years beyond the time they were due to be phased out, or by retiring planes early rather than replacing them.

The world's economic woes have put an industry that functions on low margins under enormous pressure to reduce bottom lines. Airlines have been forced to rethink their strategy of network expansion, which was once a booming global market. For many airlines, the pressing priority is short-term profitability, whereas for others, their main concern is survival.

Not so long ago, there was less risk involved in running what at first seems like an unprofitable route to open a market that would bear fruit in the future, but times have changed. Airlines were once able to afford long-term strategies in order to expand their global network. However, the economics of long-haul flights in particular are now being scrutinised carefully.

'The industry is definitely affected by the economic climate,' says Jurriaan Stelder, senior network planner for KLM Royal Dutch Airlines. 'Our horizon is much shorter. Previously, when there

was good economic growth, we could extrapolate that growth – especially on long-haul routes – but that has all come to a stop in the past nine months. Extrapolation is in the waste bin. I'm confident that growth in long-haul routes will come back when the economy improves, but the questions remain: when that will be, and how many long-haul players will be left?'

KLM is part of the Air France-KLM group, the world's largest airline in terms of total operating volume and passenger miles. Like many airlines, KLM has been forced to reduce capacity. Declining demand has prompted it to cut its summer schedule for long-haul and medium-haul networks, but the result is a leaner and fitter schedule.

'We can't afford too many loss-making routes,' remarks Stelder. 'The industry as a whole is less tolerant of such routes so, for example, we have closed the service to Hyderabad in India. Long term, there is certainly a growth opportunity there, but for now we can't afford to make a loss on it.'

The focus is on making adjustments to the short-haul network, and the planning horizon

has come much closer, but Stelder warns of the dangers of putting long-term, strategic planning on the back burner.

‘We are making adjustments in the two to six-month period, during which we usually leave the network stable,’ he says. ‘Now we have to look at reducing capacity and, in a few cases, increasing capacity. At the same time, we have to know what the plan will be when the economy improves and long-haul starts to show moderate growth again.’

### **Founded on flexibility**

The network planning process is made more challenging by uncertainty about macro-economic factors, but strategy must hold its place alongside tactical thinking. For KLM, this means considering many possible futures.

#### **TRANSATLANTIC JOINT VENTURE**

In May 2009, the Air France-KLM Group and Delta Airlines announced their joint venture to operate their transatlantic businesses on routes between North America and Africa, the Middle East and India, as well as on flights between Europe and several countries in Latin America.

The two lines, which are members of the SkyTeam Alliance, said that the venture represents approximately 25% of total transatlantic capacity with annual revenues estimated at more than \$12 billion.

President and CEO of Air France-KLM Pierre-Henri Gourgeon said that the agreement to pool revenue and costs for flights between Europe and the US, and to cooperate closely on many other flights, would significantly lift both carriers’ revenues while cutting costs. The \$300 million total should be achieved by the beginning of next year, but the pact would also offer big synergies this year.

‘This strategic partnership puts us in a good position compared with other major alliances, which are active in the world’s leading long-haul market,’ said Gourgeon. ‘By integrating our transatlantic operations, we will give our passengers what they desire: more choice, more frequencies, more convenient flight schedules and superior customer service. By optimising the use of our pooled resources, this joint venture will help us weather the current economic situation and protect our product offering.’

‘The structure of this joint venture, in which we operate as a single business where we consensually develop our strategies and share revenues and costs, provides the incentives for us to collaborate in a way that generates benefits for our customers, shareholders and employees of our three airlines,’ said Richard Anderson, CEO Delta Airlines. ‘Customers will benefit from the stronger competitive and financial position of our respective airlines.’

The venture is a long-term arrangement that can only be cancelled with a three-year notice, after an initial term of ten years.

‘There is much uncertainty over when the economy will recover, so we have to do scenario planning,’ explains Stelder. ‘We are looking at what will happen if economic conditions improve in 2010, but we also have to look at what will happen if the global economy becomes even worse next year. We have to simulate many different scenarios using our historical data on traffic and costs. We must then extrapolate many different outcomes, from the most optimistic to the most pessimistic. We then choose the one with the least downward risk.’

The key factor in shaping the network is to maximise the trade-off between service delivery and cost.

‘The transfer network is the priority now,’ adds Stelder. ‘We need to respond to economic conditions, so we have to find ways to reduce capacity without affecting the connectivity we offer. We have to maintain a solid position in connecting traffic in Europe. If, for example, we cut a flight to Birmingham, we have to ask how we will maintain connectivity to long-haul connections within two or three hours. There is a trade-off to be made with the hub system – do we phase out aircraft or do we become stricter on the times that flights are planned? The problem is choosing between saving real cost in the short term, or possibly gaining future revenues that remain uncertain.’

**‘We are fortunate to have the right IT tools to help with planning and network building!’**

Such decisions are now part of a constant review process. KLM adjusts and reviews network planning and flexibility issues on a weekly basis but maintains a long perspective. The flexibility in its fleet enables it to achieve this balance.

‘You need the fleet to be flexible,’ explains Stelder. ‘We either have downward flexibility by phasing out older aircraft and not replacing



## FUTURE ROUTES

them, when we would usually expand the fleet every year, or an upward flexibility, where we keep aircraft that were due to be phased out and fly them for an extra two or three years. The only problem with this is making sure that cockpit crews are available.'

### Difficult decisions

Keeping tactics and strategy in balance is no easy task, but the first step is to have realistic expectations. Stelder believes the best course of action is to be clear about where an airline's strengths and weaknesses lie and adapt its network accordingly.

A realistic perspective on where the opportunities lie will enable quick thinking and prompt action. This has proven to be the case at KLM, where decisive action was taken in the early stages of the current economic crisis.

our key strengths is that we have learned to adapt our cost levels. We have reduced costs – including fixed costs – without the difficult programmes of job layoffs.'

Nevertheless, there have been cutbacks in staff. Air France-KLM recently announced a further reduction in its workforce for the year ahead. But once again, it is not alone in having to take



'We are very responsive in terms of cost and activity, but the key challenge will be when the economy picks up. We must ensure that activity increases again.'

'KLM is very well placed in these challenging times,' says Stelder. 'This is the most difficult environment the industry has experienced in more than 40 years. One of our priorities is to have worldwide long-haul coverage. We are not reliant on niches as, for example, Iberia is on South America, so we are less vulnerable. We are fortunate in that we have the right IT tools to help with planning and network building, but it comes down to logic and experience. One of

such steps, and the quick reaction of senior managers to the onset of the global downturn has enabled it to be more selective and strategic in where those cuts are made.

'We have very good communication within the organisation and we felt a sense of urgency early on in the economic crisis,' says Stelder. 'Our top management saw the severity of it in its earliest stages and acted very quickly. We are very responsive in terms of cost and activity, but the key challenge will be when the economy picks up. We must ensure that activity increases again.'

Every airline is feeling the pinch in these economically uncertain times, and there is a necessary focus on cost control and short-term capacity requirements. Planning, modelling and decisive action will not rule out every tough decision an airline has to make, but they will be vital in helping airlines not only to survive but also to look beyond the recession and prepare for better times to come. ○

### JURRIAAN STELDER

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