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Abstract

In recent years legacy airlines have struggled, while low-cost carriers have achieved success. The original low-cost operating model, created by Southwest Airlines, has been adapted by airlines worldwide. Previous studies argue that the more a company adheres to the original model, the more successful the airline will be. Little academic study of the current state of the low-cost model exists. The researcher seeks to address this gap through qualitative methods and a case study involving Spirit Airlines. Spirit is currently one of the most successful low-cost carriers operating in the United States. The operating strategies of Spirit Airlines are analyzed to determine the extent to which the company follows the original low-cost operating model.

Keywords: low-cost airline, low-cost model, ancillary revenue, Spirit Airlines

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Two recessions, terrorism, high oil prices, intense competition, financial restructurings, and consolidation have transformed the airline industry over the last ten years. Battling profit margins near zero, averaging just 0.3%, air carriers have been forced to fine-tune business models with an aim of minimizing losses through lowering operating costs, eliminating unprofitable routes, and grounding older, less efficient aircraft (Jenkins, Mark, & Miller, 2011). Forecasts predict that as the economy continues to recover, the total number of takeoffs and landings and the number of passengers who board U.S. airlines will continue to climb (FAA, 2012). Michael Huerta, acting FAA Administrator, stated, "This year's forecast predicts that the industry will grow from 731 million passengers in 2011 to 1.2 billion in 2032" (FAA, 2012, p. 3). Along with growth, the FAA (2012) also sees a competitive and profitable industry continuing to grow over the long term despite economic uncertainty and rising oil prices.

While mainline carriers have struggled, low-cost carriers (LCCs) have experienced success. Revenues across 36 carriers jumped 19% to $58.7 billion in 2010. Operating profits more than doubled to $4.2 billion across 30 of the airlines (Dunn, 2011). Andrew Lobbenberg, RBS Aviation Analyst, explained,

> The low-cost business model has performed well through the recession, and that makes sense because business and leisure travelers are seeking value during periods of recession. While the sector has had its fair share of financial casualties over the years, impressive operating margin for many carriers testify to the robustness of the model. (Dunn, 2011, para. 6)

Literature Review

Southwest Airlines, formed in 1971, pioneered and successfully implemented the original low-cost operating model. The low-cost model is characterized by specific product and operating features. Product features include: (a) low, simple, and unrestricted fares; (b) high frequencies; (c) point-to-point flights; (d) no interlining; (e) ticketless travel utilizing travel agents and call centers; (f) single-class, high density seating; (g) no seat assignments; and (h) no meals or free alcoholic drinks. Operating features include: (a) single type aircraft with high utilization, (b) secondary or uncongested airports served with short aircraft turns, (c) short sector length, and (d) competitive wages with profit sharing and high productivity (Alamdari & Fagan, 2005). While Southwest's business strategy has evolved over the last 40 years, the low-cost model has been effectively utilized by airlines worldwide.

Previous research. Alamdari and Fagan (2005) argue that in recent years the industry has witnessed a departure from Southwest's original model in pursuit of ensuring a competitive advantage, but that the more an LCC adheres to the original model, the greater the operating margin can be achieved. Francis, Humphreys, Ison, and Aickien (2006) further support this finding,

> Those who have only adopted some of the low cost features of the 'Southwest model' seem to have a greater propensity to fail. The authors predict the continued success of the low cost concept but the turbulence of the airline industry is such that it is much more difficult to forecast for individual low cost airlines. (p. 93)

The original low-cost model follows a cost leadership strategy in which an airline sets out to become the low cost producer in the industry by selling a standard no-frills product. These companies place an emphasis on reaping scale or absolute cost advantages from all sources

(Alamdari & Fagan, 2005). Many LCCs now tend to follow a differentiation strategy in which an airline seeks to be unique along some dimension that is widely valued by buyers and in turn is rewarded for its uniqueness with a premium price. "Despite deviating from the original model, these LCCs have not achieved a price premium as a reward for their extra service offerings" (Alamdari & Fagan, 2005, p. 380).

Of LCCs worldwide, Europe's Ryanair has the most similar operating and product features to the original model as well as the highest operating margin (Alamdari & Fagan, 2005). An understanding of Ryanair's operating and product features helps show how important adherence to the low cost model is. "Ryanair is the true 'low cost and no frill' LCC, with a strictly point-to-point system, an all economy configuration with no seat allocations at check-in, no designated cargo facility, no in-flight 'frills' and certainly no frequent flyer program" (Alamdari & Fagan, 2005, p. 383). Ryanair offers internet and call center ticket sales, but completely bypasses travel agent distribution channels.

Ryanair also follows the original model in its entirety in terms of operational features. "Fleet commonality gives greater flexibility to the deployment of crews, standardizes the requirement for ground equipment, leads to lower maintenance costs, and reduces training requirements and costs" (Alamdari & Fagan, 2005, p. 383). High aircraft utilization with 25 minute average turns and shorter stage lengths, along with operating to uncongested secondary airports, also helps boost Ryanair's productivity (Alamdari & Fagan, 2005).

Research by O'Connell and Williams (2005) compared passengers' selection criteria between full service and low cost carriers. Average fares of LCCs were 40 to 60% lower than full service competitors. Ryanair's fares were so low that offerings often stimulated markets, a condition unheard of by other carriers. According to O'Connell and Williams's findings,

> The evidence presented confirms the principle differences in passengers' perceptions between incumbent and low cost airlines. Passengers are selecting low cost carriers primarily because of their low fares, while passengers selecting full service airlines opt for them in part because of the additional product services they provide. (2005, p. 271)

Their study also confirms that low fare airlines have created a brand reputation with 65% of passengers not looking at any other carrier when booking travel (O'Connell & Williams, 2005). Notably, "travelers are willing to connect through secondary airports and accept no frills in exchange for low fares. Incumbents are retaining their complex and wide range of airline products as a counteractive strategy for higher fares" (O'Connell & Williams, 2005, p. 271).

Ancillary revenue. In recent years, ancillary revenues have begun playing a major part in airline profits. According to the Amadeus Review of Ancillary Revenue Results, airlines made $22.6 billion in 2011 from ancillary revenues, a 66% increase from 2009 (Lovitt, n.d.). Low-cost carriers were named "ancillary revenue champs" generating 20% of revenues through ancillary fees (Fallert, 2012). Ancillary revenues are generated through unbundling pricing and creating three types of fees: (a) "a la carte items", (b) commission-based items through partnerships, and (c) frequent flyer programs (Fallert, 2012). According to Fallert (2012), there are several reasons why airlines have unbundled pricing: (a) internet and fare search engines have strongly increased the transparency of pricing and the face value of the airline ticket has become the main driver for customer purchasing behavior, (b) oil and jet fuel prices remain high and impact profitability, (c) airlines promote the idea that unbundling reflects an advantage for the client as they will only be charged for the services they choose, and (d) ancillary fees represent a high revenue potential with extraordinary margins.

Ancillary fees have been met with mixed feelings by passengers. Lovitt (n.d.) explains,

> On the one hand, many consumers feel they're being nickeled and dimed when they have to pay for services that were once considered part of their tickets purchase; on the other, airlines note that so-called "unbundling" of fares lets travelers pay for only the services they use, which helps keep fares down. (para. 10)

One passenger states, "I love the idea that I can pick or choose what services and amenities I want, but I want those options presented to me early on so there are no surprises down the line" (Lovitt, n.d., para. 12). Given the difficulty of raising fares in the current economy, it is unlikely airlines will stop utilizing ancillary fees any time soon. "The next wave of innovation in ancillary services will come from those airlines which develop new products that support their brand positions and deliver value to the traveler by meeting their individual needs and preferences" (Lovitt, n.d., para. 17)

Spirit Airlines. Spirit Airlines is a low-cost carrier dominating the industry and actively utilizing ancillary revenues. Spirit was founded in 1964 as Clippert Trucking Company incorporated in Michigan. In 1974 the company changed its name to Ground Air Transfer, Inc., and in 1983 started doing business at Charter One, a Detroit-based charter tour operator providing travel packages to entertainment destinations. Charter One officially changed its name to Spirit Airlines in 1992 and rapidly expanded service throughout the U.S. Like most other airlines after 9/11, Spirit saw profits drop and was losing money ("Spirit Airlines History," 2011).

In 2006 Ben Baldanza took over as CEO, and along with investments from Oaktree Capital and Indigo Partners, has radically changed the company ("Spirit Airlines History," 2011). With an initial focus on expanding Caribbean and Latin American routes while closing unprofitable domestic routes, Spirit began implementing its Ultra Low Cost Carrier (ULCC)

business model and moved the main base of operations to Fort Lauderdale, Florida. As the first ULCC in North America, Spirit is now successfully expanding its route structure back across the U.S.

> Spirit strives to provide low fares with friendly and reliable service to its customers. Spirit Airline's ULCC approach liberates customers from being forced into paying for services they do not want or use, offering savings to millions in the United States, Caribbean, Central and South America. ("Spirit Airlines History," 2011, para. 7)

Research questions. While there is diverse academic literature in terms of low-cost carriers created in the early 2000s, very little academic study of the current state of the low-cost model exists. This research seeks to address the gap in literature by: (a) analyzing the operating strategies of Spirit Airlines, as they are currently one of the most successful low-cost carriers in the United States; and (b) determining to what extent Spirit Airlines follows the original low-cost operating model.

Method

Procedure

Nonexperimental research was most applicable to this study through the use of qualitative methods. Utilizing a case study, close examination of Spirit Airlines was conducted. This allowed for a detailed account of the company's operating strategies and their relationship to the original low-cost model.

Subjects

Since Spirit Airline's initial public offering (IPO) on May 26, 2011, a significant amount of documentation and archival records from both corporate and public sources has been released regarding Spirit's operating strategies and financial information. Four types of sources were

used for data collection: (a) various online and published newspaper articles; (b) documented interviews with Spirit's CEO; (c) Spirit's investor relations website; and (d) Spirit's financial presentation used at conferences worldwide.

Apparatus

The researcher utilized Spirit Airline's operating strategy to define a new model of success for low-cost carriers. Following the original low-cost model, along with utilizing ancillary revenues to increase profits, is the key to success for any airline in today's economy.

Results

"Unapologetic and unwavering in his adherence to the ultra-low-cost carrier model, Spirit Airlines chief executive Ben Baldanza puts delivering profit at the heart of a strategy that is generating returns and strong growth" (Yeo, 2012, para. 1). The goal driving all operations at Spirit is simple: to make money. In 2007, as the company transitioned to the ULCC strategy, executives looked to successful low-cost, low-fare companies as a model for their change. Ryanair, AirAsia, and Southwest were the answer. Ben Baldanza explains,

> "The business model has changed, the old one didn't work. Spirit was a low-cost airline but not low-cost enough, and it was competing in a space that was very saturated with other competitors. Every company, no matter what you sell or what your product, has to ask what's their purpose in life, and we really couldn't answer that at Spirit. We looked at everyone in the industry. What are the characteristics of airlines that make money all the time?" (Arnoult, 2007, para. 3)

Spirit is the true low cost producer in the airline industry and over the last several years has proven the success of its operating strategy. After initially raising $150 million in its May 2011 IPO, Spirit has posted substantial profits as well as continued growth. The year 2012 ended

with a $103.8 million net profit, $416.8 million in unrestricted cash, and no debt on its balance sheet ("Spirit Airlines reports," 2013).

> Year-over-year revenue growth for the trailing twelve months is 18% and year-over-year EPS growth for the same period is nearly 12%. Spirit's year-to-date departures as of November 2012 are 20% greater than its November 2011 departures. Analysts are projecting more than 19% EPS growth per annum for the next five years. (Jenks, 2013, para. 4)

When comparing operating margins to other carriers for the 3rd quarter 2012, Spirit leads the industry at 13.7%. In comparison, JetBlue was 5.0% and Southwest was 4.0% ("An Airline Run," 2012).

Spirit's strong financials are backed by the lowest costs amongst competitors. Cost per available seat mile (CASM) provides the cost in cents to operate each seat mile offered and is calculated by dividing operating costs by the number of seats multiplied by the number of miles. "The lower the CASM, the easier it is to break even and to then make a profit" (Jenks, 2012, para. 2). Spirit's CASM is 10.20 compared to: (a) Southwest 11.05, (b) JetBlue 12.55, (c) Delta 16.03, and (d) American Airlines 16.93 ("An Airline Run," 2012).

The heart of Spirit's strategy lies in being the low-fare leader in the markets that are served, having a total fare that is at least 25% lower than the currently available average ticket price (Jones, 2012). According to Baldanza, "Our vision is to make sure the customer who can't afford to pay current airline prices has an option to still travel" (Jones, 2012, para. 6). While Spirit currently makes up less than 2% of total U.S. domestic and Latin American capacity serving 110 markets, there are over 400 competitive markets not yet served. Target markets must: (a) have more than 200 passengers per day each way; (b) have current high average fares;

and (c) based on current cost structure, average fare in market must be reduced by 25% and produce a before tax margin of 24-36% ("An Airline Run," 2012). In regards to market share Yeo (2012) explained, "Spirit does not care about market share, and it expects every route in its network to be profitable. If it is not, the route's frequency is downgraded or dropped all together" (para. 7).

As Spirit connects various markets, a focus is placed on point to point service rather than utilizing airports as hubs. While some airports have many flights, connecting profitable city pairs is key (Yeo, 2012). Recent consolidation events in the U.S. airline industry have created more opportunities for Spirit to grow domestically, but Mexico also has a potential for increased service (Yeo, 2012). Yeo also commented on serving smaller airports,

> New flights to smaller, "alternative" airports in the USA could also be a key component of Spirit's growth in the coming years. The carrier now operates to a number of small airports such as Latrobe (Pennsylvania) and Niagara Falls, and Baldanza believes there is more room for growth at airports such as these. (2012, para. 24)

Connecting Spirit's markets are an all Airbus fleet consisting of the A319, A320, and A321. Spirit ended 2012 with 44 aircraft, and has plans for the delivery of 24 more through 2015. Beginning in 2016 an order of 75 new A320s will begin being delivered (Yeo, 2012). The fleet is configured in a high density, single class configuration offering 178 seats in the A320, 19% more than a JetBlue A320 ("An Airline Run," 2012). The airplanes run at the highest average daily aircraft utilization rate amongst U.S. low cost carriers at 12.7 hours per day ("An Airline Run," 2012). Along with high utilization, average load factors run at 85.2% with the lowest break even fare per passenger flight segment in the industry at $58.00 ("An Airline Run," 2012).

Along with low fares, Spirit unbundles pricing and has done away with the frills that other airlines offer. Luis Perez, Dallas/Fort Worth airport's Vice President for Air Service Development commented, "Spirit is 'a la carte'. They have services you use as you need them. And, basically, that opens up a whole new possibility for people who normally would not travel if Spirit wasn't around" (Jones, 2012, para. 23). Unbundled pricing includes charging for: (a) checked bags, (b) carry-on bags, (c) seat assignments, and (d) on-board drinks and snacks ("An Airline Run," 2012). DeAnne Cabel, director of investor relations at Spirit, explained, "We are not out to rip off the customer, rather, we are trying to offer the lowest base fare by stripping out all the extras" (Malayappan, 2012, para. 4).

To help save costs Spirit also has no inflight entertainment system and does not carry any magazines. Spirit's advertising expenses are minimal with almost no traditional TV advertising, magazine placements, and Newspaper ads. Word-of- mouth referrals, opt-in email marketing, and articles and posts that dwell upon the pros and cons of targeting the consumer's bottom line dollar are relied upon heavily (Malayappan, 2012).

Unbundled pricing is just one part of Spirit's multifaceted ancillary revenue strategy. Spirit is the world leader in airline non-ticket revenue production with approximately 40% of revenue being derived from non-ticket sources ("An Airline Run," 2012). In addition to Unbundled Product, non-ticket revenue comes from Additional Travel-Related Options: (a) $9 Fare Club, (b) hotels and rental cars, (c) GDS exchange, (d) Big Front Seat, and (e) travel insurance and Other: (a) on-board advertising, (b) online advertising, and (c) co-branded credit card ("An Airline Run," 2012).

The ancillary revenue strategy not only generates revenue, but helps drive low cost behavior. Baldanza explained, "Most of the charges for optional services, they act as economic

incentives for customers to behave in a way that will cost us less money" (Yeo, 2012, para. 15). Spirit highlights several examples: (a) charge for bags means less bags to handle saving dollars and fuel, (b) charge for printing boarding passes leads to less resources needed at the airport for processing customers, (c) charge for tickets via 3rd party channels means more sales through lowest cost direct channel, (d) charge for call center makes the call center a profit center rather than a cost center, and (e) charge for items on-board makes inflight service a profit center rather than a cost center ("An Airline Run," 2012). In regards to ancillary revenue, Yeo noted,

> Ancillary revenue also has an advantage because it is not seasonal, like fare revenue, and is less elastic. Baldanza believes customers will decide which airlines to fly based on its fares, but once they've made the decision to fly to Cancun, whether they pay $20 or $30 to check a bag, it doesn't make a difference. Fares move up and down, but bag fees stay the same. There is no bag-fee war. (2012, para. 17)

Discussion

Spirit Airlines has created a successful new low cost model utilizing most of the product and operational features of the original low cost model. In keeping with the original model, Spirit's product features include: (a) low fares; (b) point-to-point flights; (c) no interlining; (d) minimal use of travel agents and call centers; (e) single-class, high density seating; (f) no seat assignments; and (g) no free meals or drinks. Through unbundling fares and additional fees, Spirit capitalizes on passengers utilizing checked and carryon bags, pre-assigned seats, and other services, turning normal airline cost centers into profit centers. Spirit's operating features include: (a) single type aircraft with high utilization and (b) secondary or uncongested airports.

Notably Spirit ignores: (a) high frequency, (b) only using short sector length, and (c) competitive wages with profit sharing and high productivity. By being blind to borders and

focusing on profitability over geography and market share, assets are able to quickly be deployed to the best markets ("An Airline Run," 2012). High frequencies and short sector lengths are counterproductive to this strategy.

While a new model of success for low-cost carriers has been defined, earlier research in regards to the low cost model is still valid. As described by O'Connell and Williams (2005), passengers still select low cost carriers because of low fares rather than product features. This is shown by Spirit's success and the company's continued commitment to offering the lowest base fares. The argument made by Alamdari and Fagan (2005), the more an LCC adheres to the original model, the greater the operating margin can be achieved, also still stands. Besides actively utilizing ancillary revenue and eliminating three original features, Spirit follows the original model.

As the low-cost airline model continues to evolve, the next step in regards to research involves two different areas. First, unbundled pricing and ancillary revenues must be studied in detail. In what ways can airlines further increase ancillary revenue? What are the long term effects of unbundling pricing on passenger purchasing trends? Second, further research is needed in regards to why the new model eliminates competitive wages and profit sharing and the long term effect on low cost airlines.

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