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The evolving low-cost business model: Network implications of fare bundling and connecting flights in Europe

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A B S T R A C T

In a context of limited organic growth, some low-cost airlines have considered business strategies that are changing two key principles of the low-cost airline business model: fare unbundling and point-to-point operations. Using a multivariate analysis we identify the influence of several route characteristics on the share that European pure low-cost and hybrid low-cost carriers have on the routes they operate. Results show that, from a network perspective, the distance between the archetypical low-cost carrier business model and the adapted low-cost carrier business model with a hybrid approach is widening. Differences are also clear between hybrids offering connecting services and hybrids offering fare bundling. The results are also important from an airport policy perspective, since secondary airports and legacy airports in transition could be able to reduce the gap between them and the main hub airports.

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1. Introduction

Low-cost travel is becoming the dominant way of flying within Europe (Dobruszkes, 2013). However, there are signs of a slowdown in the organic growth of low-cost carriers (LCCs) due to decreasing average frequencies and increasing average route distances, which is forcing LCCs to adopt other business strategies for growth (De Wit and Zuidberg, 2012), including the possibility of establishing long-haul low-cost operations (Morrell, 2008) and hybrid low-cost business models (Klophaus et al., 2012). These evolutions make it more difficult to define the LCC business model; in fact, according to Mason and Morrison (2008) several business models coexist and can be categorised under the "low-cost carrier" label. Yet, discussions on long-haul low-cost and hybrid low-cost have developed relatively independently from each other, but both are related with changes in two fundamental principles of the low-cost business model: fare unbundling and point-to-point operations.

The unbundling of fares is one of the characteristics of the archetypical LCC business model. The fare unbundling strategy is aimed at attracting price-sensitive passengers and competing on base ticket fares. In Europe, this strategy can be traced back to easyJet discounting fares for tickets booked through their preferred channel (direct online tickets were discounted at point-of-sale by £2.50 per sector in 1997), and the introduction of separate fees for various items (by 2005 these included credit card fees, change fees, partner fees, excess baggage and in flight food and beverage). These innovations were introduced to customers as a way of aligning the variable costs borne by the airline to provide such services to the cost of providing them. If a customer does not want to pay for a bag to be carried in the hold, the airline will have lower ground handling costs, which may be reflected in a lower base fare for that customer. All passengers paid a similar base fare, but those looking for a better level of service (e.g. larger leg-room) or additional services (e.g. in flight meals) could purchase them as an ancillary service (i.e. "à la carte fees").[1] However, the unbundling strategy is rapidly changing and by 2013 an increasing number of low-cost carriers have introduced a fare category system in order to offer bundles of different services that used to be sold as independent ancillary products. Bundling services can help airlines to standardise their offering and have better control on the level of service provided to the customer, which is seen as important for capturing a wider range of passengers and targeting new upmarket segments

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[1] It should be noted that fare unbundling also existed in the US domestic market and was used by Southwest.

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of the market by the airline.

Another of the fundamental characteristics of the archetypical low-cost business model has been point-to-point service. This allowed for lowering the cost structure by providing a simple operation and management model. Offering point-to-point services also lets airlines schedule their services at the right time of the day to compete with other airlines without being subject to the imperatives of a connecting wave-system. However, this is also changing as some low-cost carriers are starting to connect some of their flights, feeding other airlines and code sharing (e.g. JetBlue in the US has begun code sharing with Emirates, and Air Berlin with Etihad). In a market with limited organic growth, such as Europe, this has a twofold objective. On the one hand, it allows for capturing the increasing number of passengers who are already doing self-help hubbing[2] (O'Connell and Williams, 2005), which can help reduce the route density problem (De Wit and Zuidberg, 2012). On the other hand, it allows for connecting more distant markets by feeding the longer flights that the low-cost carrier offers. To take advantage of density economies, the sector distance has ideally been around less than 1500 km, which allows for flying as many sectors-a-day as possible and for increasing aircraft utilisation. In relation to the previous point on price bundling, a better level of service and comfort could also contribute to customers withstanding longer travel times.

Although these two key changes have significant consequences for the competitiveness of the low-cost airline business, there is a limited number of new research on the recent changes and evolution of this business model.[3] In this paper we try to add to the discussion by analysing the network implications of fare bundling and connecting flights in different low-cost carrier models, i.e. archetype low-cost models and hybrid approaches. We aim to identify the influence of several route characteristics on the share that archetype low-cost and adapted low-cost carriers with a hybrid approach have on the routes they operate.

The paper is structured as follows: Section 2 discusses the evolution of the low-cost business model with special regard to fare bundling and connecting flights, Section 3 introduces the data and the empirical model used for the analysis. Section 4 presents the results of the estimation and, finally, Section 5 discusses the results and their policy implications.

2. Evolving low-cost business models

2.1. Market forces, business models and self-transformation

The airline industry has been losing value consistently over the last 20–30 years and some are starting to recognise that the problems of the airline industry are not just due to cyclical exogenous shocks (Mason and Alamdari, 2007; O'Connell, 2011) or other exogenous cost drivers, such as taxes and fuel (Borenstein, 2011), but that the issue is mainly structural since the gap between long-term returns on capital and cost of capital is widening (Button, 2003; Borenstein, 2011). The long-term financial problem of the airline industry is one of its ‘ugliest’ aspects (Goetz and Vowles, 2009) that leads to a wide range of fundamental changes that take shape in the form of bankruptcies, terminations, mergers and acquisitions.

The reaction of airlines to growing market pressure has been to increase the firm's flexibility by decreasing costs, especially those related to labour. However, such measures have not led to significant changes in the existing business development path of LCC firms; on the contrary, they reinforce the low-cost nature of this type of airline in a sort of continual race to the bottom. Yet, the significance of the 2008 financial crisis could have been a definitive event that fostered the emergence of novelty in the low-cost business model. Business model innovation and technology innovation are the main sources of self-transformation for firms. The creative capacity of economic agents (Boschma and Martin, 2007) to evolve accordingly and to adapt to the selective market forces and changing institutional settings is essential for their survival. In this regard, business models represent a new dimension of innovation, which spans the traditional modes of process, product and organisational innovation, and involves new forms of cooperation and collaboration (Zott et al., 2010). According to Seelos and Mair (2007) the business model is a set of capabilities configured to enable value creation consistent with either economic or social strategic objectives. For the area of our concern, one of the alternative approaches to the archetypical low-cost business model is the adapted business model that takes a hybrid approach.

2.2. Towards a hybrid approach

The low-cost airline business model can take a number of forms (Francis et al., 2003; Edwards, 2010) and cost savings can be achieved from different sources (Williams, 2001). While some identify low-cost carriers as those airlines that have a distinctive feature, such as using a single-fare class over their whole network of routes (Fageda and Fernández-Villadangos, 2009), others use different methods, such as the product and organisational architecture (POA) approach, to classify and relate key elements of airline business

Table 1
Archetypical and adapted low-cost carrier business model practices.

	Archetypical LCC	Adapted LCC with hybrid approach
Fleet	Single type	Single type or mix
Aircraft type	Narrow body	Narrow body and wide body for long-haul
Type of airport	Regional (Ultra LCC) and/or primary and/or secondary	Primary and/or secondary
Code sharing	No	Can provide code sharing
Transfer between flights and feeding services	No	Can provide transfer between flights
Member of global alliance	No	Can be member
Sector length	Ideally from 500 to 1500 Km.	Can be longer than 2000 Km.
Long-haul flights	No	Can be long-haul
Single class cabin	Yes	Yes
Fare bundling	No	Yes, different fare bundles offering different levels of service
Sales distribution channel	Mostly internet	Mostly internet, but also GDS
Frequent flyer programme	No	Can offer FFP
Frills[a]	No frills	Depending on fare bundle

[a] Frills may include, among others: complimentary in-flight services, free checked baggage, room reserved on the aircraft for hand luggage, food on board, free flight changes, exclusive check-in desks, etc.
Source: Authors' own elaboration from Mason and Morrison (2008), Klophaus et al. (2012) and Doganis (2013).

[2] Self-help hubbing are connections between flights that are not offered by airlines, but that passengers arrange themselves between two independently operated flights. According to Malighetti et al. (2008) two-thirds of the fastest indirect connections in Europe are not operated by the alliance system and could be exploited to enable higher levels of connectivity.

[3] Some examples are Francis et al. (2007), Morrell (2008), Mason and Morrison (2008), Pels (2008), Wensveen and Leick (2009), Douglas (2010), Daft and Albers (2012), and Klophaus et al. (2012).

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