V. Airline Industry Council: Lean Production in the Air: Low-Cost Competition Taking Off in the Global Airline Industry and Implications for Employment Relations

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Low-Cost Competition in the United States

Nancy Brown Johnson
University of Kentucky

Abstract

This paper contrasts low-cost carriers (LCCs) in the United States with Southwest Airlines in terms of structure, product, and relationships. JetBlue emulates the Southwest model most directly and performs well. AirTran also performs well but by using an approach that is more consistent with the legacy carriers. Remaining LCCs have struggled to be consistently successful, suggesting that the environment for airlines is exacting and requires a tight strategy for success in order to keep costs consistently below low fares.

The American airline industry is no longer profitable. The industry as a whole has lost money every year since 2001 (Air Transport Association, 2005). In the last five years it has faced recession, rising fuel prices, September 11, increased security requirements, the SARS threat, pricing transparency arising from the Internet, ticketless travel, and a host of new entrants. The legacy carriers have particularly suffered: Delta, Northwest, US Air, and United are in bankruptcy, and the remaining nonbankrupt legacy

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Author's address: 35 Gatton College of Business and Economics, Lexington, KY 40506-0034

carriers (Alaska, American, and Continental) have failed to achieve consistent profitability. Low-cost carriers (LCCs) have performed better on average than the legacy carriers, and some have even performed well. Southwest and JetBlue clearly dominate these groups with ongoing profitability. AirTran has emerged from bankruptcy and since has had positive returns. On the other hand, low-cost carrier status does not guarantee solvency: ATA is in Chapter 11; Frontier, Spirit Air, and America West find consistent earnings elusive; and Independence Air and Song have closed.

This paper is designed to provide an overview of the status of the low-cost carriers and examine whether a systematic pattern of structure, management, and product accounts for the relative success of these carriers. Southwest Airlines serves as the benchmark: they have had over thirty years of success in a cyclical industry with numerous and sustained periods of extreme challenges. The results of this cursory analysis suggest that prolonged performance requires a sophisticated and complex system that integrates multiple dimensions of performance. What is also clear is that no one formula for success exists, supporting the principle of equifinality—that there are multiple paths to success.

Overview: Legacy Carriers Versus the Low-Cost Carriers

The legacy carriers face the greatest threats to their survival. They tend to have greater operating costs and less flexibility than the low-cost carriers, stemming in part from somewhat immutable cultures and structures. Their workforces are more mature, commanding higher wage structures and greater pension obligations than those of the younger low-cost carriers. Finally, they have a history that makes innovation and flexibility difficult in the current hyper-competitive environment. As a group they have responded to threats by retrenching and cutting costs. Between October 2001 and the end of 2003, legacy carriers cut operating costs by 14.5 percent and seat capacity by 12.6 percent; labor carried the brunt of the cuts, with 43 percent of the savings coming from labor costs (Hecker 2004). Labor costs tend to represent the major segment of costs that are malleable in the short run, with capital fixed and fuel costs given. The emphasis on cutting labor costs has contributed to strained labor relations in many of the carriers. Concomitantly, while the legacy carriers were retrenching, the low-cost carriers stepped in to fill a portion of the gap. Market share of LCCs had risen to almost 24 percent of the origin and destination market by 2002 (Ito and Lee 2003). Between 2001 and 2003 LCCs increased seating capacity by 26.1 percent and expanded their operations, contributing to a 9.8 percent increase in operating costs (Hecker 2004). Labor costs rose by 21 percent between 2001 and 2003, representing a key portion of the LCCs' cost expansion. More recently, the Bureau of Transportation Statistics reported that in the second quarter of 2005, four LCCs (Southwest, JetBlue, AirTran, and America West) reported a profit (Bureau of Transportation Statistics 2005a). According to this report, six of the seven legacy carriers (Alaska, Continental, Delta, Northwest, United, and US Air) continued their stream of losses. Of the seven network carriers, only American posted a second-quarter operating profit. Three low-cost carriers (Frontier, Spirit, and ATA) also had consistent operating losses since the second quarter of 2004.

The carriers' financial status has translated into employment trends. The legacy carriers have reduced employment substantially to the point where they are operating with slightly over 70 percent of the employees they had in 2000. Employment was at almost 440,000 in 2000 and fell to approximately 315,000 in 2004 (Bureau of Transportation Statistics 2005b), with about half (62,000) of the jobs lost before 2002 and about the same number disappearing after 2002. In contrast, the LCCs expanded as a group by a modest 10,000 employees. Although the low-cost carriers are gaining employment, their employment gains represent less than 10 percent of those jobs lost by the legacy carriers. In the 1980s the new entrants' success was thought to be based upon non-union status. For the most part, low-cost carriers have unions in their major occupational groups. JetBlue is the only low-cost carrier that is totally non-union.

On the other hand, being a low-cost airline does not guarantee success, as several of the LCCs are struggling. Southwest Airlines, at thirty-four years of age and consistent profitability, is held as the industry darling—a model of sustained success. Many scholars treat Southwest as distinct from the remaining carriers because of its sustainability and its presence has such a significant effect on the competitive landscape (Morrison and Winston 1995). Using Southwest as the baseline, we contrast the other low-cost carriers.

Southwest

Consistent profitability since its founding over thirty years ago has made Southwest the role model in an industry where losses are common. The key to Southwest's success is multidimensional. Gittell (2003) attributes its success to a trio of factors: product, structure, and relationship. The structure component forms its basis in point-to-point routes and a single aircraft type; simplicity is at the root of a product that includes snacks rather than meals and no reserved seating. Relationships, however, link the structure and product components and represent a crucial component to Southwest's success (Gittell 2003).

Employees are at the heart of Southwest's culture. Southwest touts an inside-out brand strategy that makes employees, not customers, the focus of the brand (Johnson 2005). The belief is that if employees are taken care of they will in turn take care of the customer. The mission statement of Southwest, posted prominently on their Web page, includes a postscript to employees: "We are committed to provide our Employees a stable work environment with equal opportunity for learning and personal growth." In a recent interview David Kelly, Southwest CEO, indicated that Southwest's compensation philosophy is that the airline should share wealth with employees and that a pay cut for employees would signal a failure on Southwest's part (Warren 2005). Although Southwest decreased employment by 2,000 employees between 2003 and 2004, they did so without using layoffs (Bureau of Transportation Statistics 2005b). They operate in a union environment and openly state that they view unions as their partners (Johnson 2005). Some contend that the gap between Southwest and competitors is narrowing and that their profitability can be attributed to their hedging of fuel. They continue to look for efficiencies and recognize that their dominance as a successful carrier is being challenged (Johnson 2005).

JetBlue and AirTran: Also Successful

Although both carriers are doing well, JetBlue and AirTran are a study in contrasts. JetBlue openly acknowledges that it has emulated components of the Southwest model, but it has provided its own stamp with an emphasis on using technology and innovation to augment productivity (Ford 2004). A heavy investment in human resources is a significant part of their strategy, including significant care devoted to selection and training (Ford 2004). They also use profit sharing and empower employees to make decisions based upon their five key values—safety, caring, integrity, fun, and passion (Ford 2004). Their strategy is innovative. Some innovations involve employees, such as their call-center staffing strategy, which uses predominantly part-time mothers working from their homes. Other innovations are related to new products, as in their pioneering introduction of televisions on seat backs.

AirTran's strategy is essentially consistent with the old-style legacy carriers (hub-and-spoke network, high service), while keeping costs low. AirTran, ValueJet renamed, targets business travelers. AirTran focuses on efficiency and leanness. They realize their efficiencies through cross-training that enables them to staff gates with as few as five people when other airlines employ fifteen (Sloan 2003). Their pilots earn 70 percent less than Delta's, and work rules allow the pilots to fuel aircraft when necessary. Their labor costs are 29 percent of operating expenses; the industry average is 40 percent (Sloan 2003).

The Struggling Low-Cost Carriers

The struggling low-cost carriers appear to use a variety of strategies that, on average, appear to be less publicly articulated.

Frontier. Frontier was started in 1994 to fill an underserved niche market and to feed larger carriers in the Denver market ("Company Profile" 2005). Focusing on becoming a low-cost carrier with Denver as its hub, Frontier targets vacation travelers. The airline has a heavy marketing-oriented focus including a new ad campaign—"a different kind of animal"—and many agreements with sports teams and other high-profile companies. In an attempt to become more efficient, the airline has recently acquired a number of new aircraft to have one of the youngest fleets in the industry. By its own admission, the airline is casual and encourages employees to be themselves (Kass 2005). There is some evidence that the airline values employees: their 2005 annual report includes a statement from the CEO recognizing the employees' hard work and apologizing for the lack of profitability and profit-sharing bonuses. Their pilots and mechanics are unionized, but their flight attendants did not support the Association of Flight Attendants–Communications Workers of America (AFA-CWA) organizing attempt in the summer of 2005 (National Mediation Board 2005). In 2005 CEO Jeff Potter earned a modest salary of $275,000 with $11,000 in 401(k) matching funds (Kass 2005). Frontier faces a significant challenge in the future as Southwest plans to enter the Denver market in 2006.

America West/US Airways. America West has merged with US Airways to become the nation's largest low-cost carrier. The airline will operate under US Airway's name but will use Phoenix as its headquarters—America West's territory. Many remain skeptical that this merger will lead to success given that US Airways has been in bankruptcy twice in the last decade and profitability has recently eluded America West. For a time the airlines will continue to operate separately. The newly configured US Airways argues for a strategy that appears to be based upon "synergy" of right-sizing the fleet, improving connectivity, and better utilizing assets ("US Airways" 2005). Nonetheless, many remain skeptical that the new US Airways can successfully merge two workforces and two cultures ("US Airways Faces Challenges" 2005). Although the pilots and flight attendants at both carriers share the same union (Air Line Pilots Association [ALPA] and AFA-CWA) the merging of seniority lists remains thorny as American West is newer but also the acquiring carrier. Presently, the two local unions have begun to negotiate a joint agreement ("US Airways and America West" 2005). The merged carriers' customer service representatives have formed an alliance between the International Brotherhood of Teamsters (IBT) and the CWA known as IBT-CWA and have negotiated a transition agreement with the newly formed US Airways (IBT 2005). The old US Airways has been in bankruptcy twice during this decade and has decreased its workforce by 57 percent (Bureau of Transportation Statistics 2005b). Prior to the merger America West's performance had been uneven.

ATA. ATA, the airline formally known as American Trans Air, was founded in 1973 and achieved major status in 2000 (ATA 2005). ATA operated until recently under the tight reign of the founder, George Mikelsons, with Chicago Midway as its hub (Daniel 2004). In October 2004 it filed for bankruptcy. Mikelsons indicated that cutting labor costs was a priority following bankruptcy, although reports indicated that ATA has some of the lowest costs in the industry (AirWise News 2004; Daniel 2004). Since that time, it has developed close ties with Southwest. In the last year Southwest was selected to take over ATA's gates at Midway; they entered into a code-sharing arrangement with ATA, and John Denison, a retired Southwest executive, took over as CEO. The question remains as to whether this Southwest influence will change the airline's culture and fortunes.

Analysis

A cursory analysis presented in Table 1 suggests that low-cost carriers use a variety of strategies and tactics to achieve low costs, many of which diverge from the Southwest model. JetBlue for the most part openly emulates South-

TABLE 1
Product, Structure, and Relationships of LCCs

Airline	Structure	Product	Relationships
Southwest	Point–to–point, single aircraft	Simplicity	High
JetBlue	Mainly point–to–point, single aircraft	Innovation	Strong relationships, non–union
AirTran	Atlanta hub, single aircraft, some point–to–point	Full service targeting business consumer	Cross–utilization and efficiency
Frontier	Denver hub, connecting traffic key, transitioning fleet	Strong marketing, "a whole different animal," no first class	Contends strong, casual culture; employees encouraged to be themselves
ATA	Hub at Midway	Scheduled service, commercial and military charters	Low labor costs
America West	Merger with US Air makes largest low-cost carrier, hub-and-spoke	Innovation	Uneven

west, including its investment in human resources, but it strives to innovate and find new ways to achieve low costs rather than employ the simplicity model. AirTran, on the other hand, operates much more like a legacy carrier of the past in that it has a hub and many amenities. Its success is based in part upon keeping labor costs to a minimum through the cross-training of workers. The remaining three carriers, whose fate is the most precarious, operate with a hub-and-spoke system. Their products and cultures are less publicly accessible. Each faces unique challenges. Frontier will encounter Southwest head-on in Denver, but ATA has joined forces with Frontier and put a former Southwest executive at its helm. US Airways has become the largest low-cost carrier as a result of the merger, but strong historical evidence shows that size is not necessarily a precursor to success—particularly when relationships are tense with the merger of cultures that already are strained.

LCCs have taken a variety of approaches with mixed success. What remains clear is that charging low fares by no means guarantees financial security even as they take over a larger share of the market. Perhaps this group is better dubbed "low-fare carriers": it remains questionable as to whether they can achieve costs lower than their fares.

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