

ANCILLARY REVENUE REPORT SERIES FOR 2011

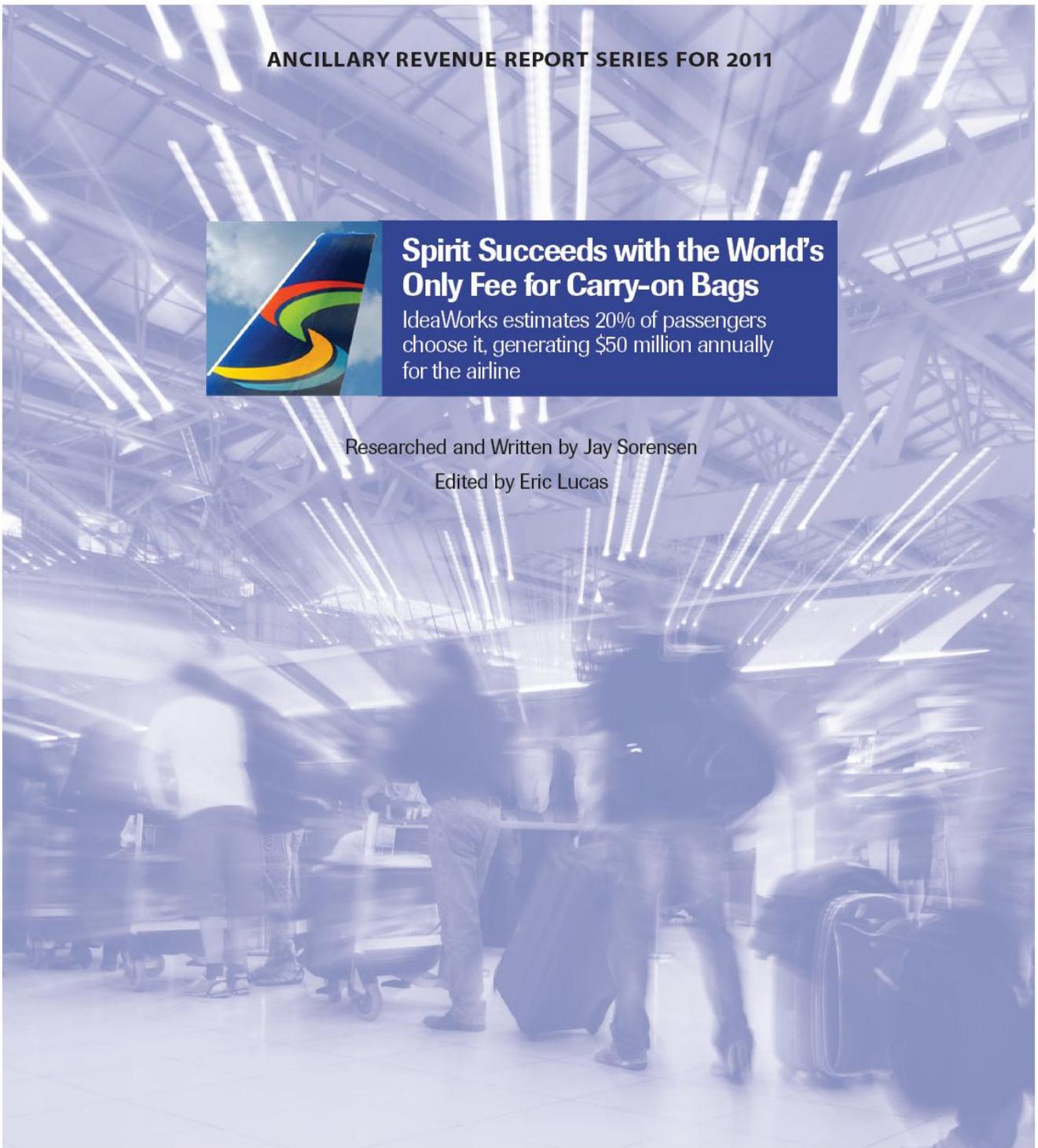


**Spirit Succeeds with the World's
Only Fee for Carry-on Bags**

IdeaWorks estimates 20% of passengers choose it, generating \$50 million annually for the airline

Researched and Written by Jay Sorensen

Edited by Eric Lucas



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Issued 19 December 2011

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IdeaWorks does not have a client relationship with Spirit Airlines. Jay Sorensen, the author of this report, does not own shares in the airline.



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About Jay Sorensen, Writer of the Report

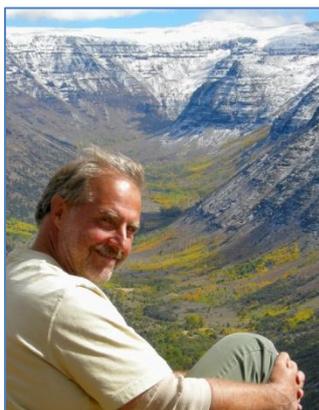
Jay Sorensen's research and reports have made him a leading authority on frequent flier programs and the ancillary revenue movement. For 2011 he was a speaker at the World Low Cost Airlines Congress in London and the IATA Passenger Services Symposium in Singapore and the MEGA Ancillary Revenue and FFP Event in Miami. His published works are relied upon by airline executives throughout the world. The 2010 Guide to Ancillary Revenue was the third edition of this popular report; it is regarded as a global resource on the topic of a la carte pricing. IdeaWorks also published its first Guide to Loyalty Marketing in 2010.



Jay, with sons Aleksei and Anton, on the top of Brokeoff Mountain in Lassen Volcanic National Park in northern California.

Mr. Sorensen is a veteran management professional with 27 years experience in product, partnership, and marketing development. As president of the IdeaWorks consulting firm, he has enhanced the generation of airline revenue, started loyalty programs and co-branded credit cards, developed products in the service sector, and helped start airlines and other travel companies. His career includes 13 years at Midwest Airlines where he was responsible for marketing, sales, customer service, product development, operations, planning, financial analysis and budgeting. His favorite activities are hiking, exploring and camping in US national parks with his family.

About Eric Lucas, Editor of the Report



Eric, at his favorite summer retreat, Steens Mountain, Oregon.

Eric Lucas is an international travel, natural history and business writer and editor whose work appears in MSN/Bing Travel, Michelin travel guides, *Alaska Airlines Magazine*, *Westways Magazine* and numerous other publications. Founding editor of *Midwest Airlines Magazine*, he is the author of six books, including the 2009 Michelin *British Columbia Green Guide*. Eric has followed and written about the travel industry for more than 20 years. He lives in Seattle, Washington, where he grows and sells organic garlic; visit him online at www.TrailNot4Sissies.com.



Add more to the trip

Add Ancillary Services

CAN ANCILLARY SERVICES SOLVE THE PRICE COMPARISON CONUNDRUM?

In this report you will read about how a lot of airlines are earning a lot of money selling ancillary services.

This is partly an illusion. Some airline ancillary services earnings aren't additional revenue but shifted revenue. Airline base fares are at an all time low and ancillary services are supposed to make up the difference.

But can they do more than that? Can they shift the base of comparison from price to service? Behavioural economists talk about "priming". To understand this, think of the following experiment.

Ask a person to think of a number between one and ten. Then ask them how much they would pay for a service. Then ask someone else to think of a number between 500 and a thousand, and ask them how much they would pay for the same service. Chances are, person 2 will feel much more generous than person 1.

So low base fares and low-fare search brings out the miser in all of us. Amadeus is trying to counter this by building

service-based search into its low-fare search tools. This would allow, for example, people looking for a flight on an online travel agency to search for all flights which include checked bags in the ticket, or all flights with extra leg-room. The idea is to prime users to think about service.

Can ancillary services shift the base of comparison from price to service?



Spirit Succeeds with the World's Only Fee for Carry-on Bags

IdeaWorks estimates 20% of passengers choose it, generating \$50 million annually for the airline.

It seems unlikely a report title could include these words – **succeeds, fees, and carry-on bags** – while maintaining contact with reality. Nonetheless, kind reader, please suspend your doubt as IdeaWorks tells the tale of a most amazing fee. The Merriam-Webster Dictionary defines “success” as a “favorable or desired outcome” and “the attainment of wealth, favor, or eminence.” By this definition, Spirit Airlines has indeed created success from an a la carte fee that every other airline has refused to adopt and even fears to speak of. Carry-on bag fees seem to share the same import as the name of Lord Voldemort, the antagonist in the Harry Potter series. Harry Potter fans know mere mention of his name risks unspeakable misfortune.

But Spirit hasn't enjoyed success by practicing dark arts. The airline has become a profit leader (and a darn good stock investment) through aggressive implementation of a la carte services, to include fees for checked and carry-on bags. Passengers are free to choose, and have been selecting the carrier in ever-increasing numbers. The airline flew 24.5 percent more passengers in the 12-month period following introduction of the carry-on fee than in the one-year period when carry-ons were free of charge. And all these passengers are generating spectacular financial results: profit margins in excess of 11 percent¹ trample the puny or negative results posted by American, Delta, JetBlue, US Airways, United, and even Southwest. Spirit's brand of unbundled service has obviously struck a chord with American consumers.

Fees change behavior and generate revenue

“Actions followed by good outcomes are likely to reoccur, and actions followed by bad outcomes are less likely to reoccur.”² That's the theory developed by Professor B.F. Skinner in 1953. And it's a philosophy that influences the ancillary revenue strategy of Spirit Airlines. According to Ben Baldanza, CEO of Spirit Airlines, “The fees we charge do two things. They are not only there to drive revenue. Another absolutely strategically important aspect is to create economic incentives for customers to behave in ways that lower our costs.”³



Birds of a feather? Professor Skinner (1904-1990) and Ben Baldanza (right) credit their success to behavior modification.

¹ USDOT press release dated 19 September 2011, Financial Data for the First Quarter of 2011.

² Skinner, B.F. (1953) Science and Human Behavior, New York, Macmillan.

³ Ben Baldanza, CEO of Spirit Airlines, IdeaWorks interview conducted 29 November 2011.

Baldanza is quick to add that lower costs for Spirit equal lower fares for consumers - - the theory being that the cost of providing baggage service is only borne by those using it. Bag fees have become prevalent in the US with fees charged by the five major airlines since 2008: American, Delta, Continental, United, and US Airways. However, these carriers have not effectively dealt with the behavioral consequence of charging for checked bags . . . it gives passengers a clear economic incentive to carry more bags onboard.

The Spirit CEO may have channeled the spirit of Professor Skinner when he decided to influence the unintended outcome of too many carry-ons. The path Spirit decided upon was to assess a new fee for the carry-on bags that only fit in overhead bins. Voila, in an instant, the CEO had identified a method to generate revenue and charge a fee to discourage carry-ons . . . a device Skinner would label a “bad outcome.”

It’s a strategy the airline used before. Consumers realize savings when baggage fees are paid during the booking process . . . and not at the airport. Likewise, booking a reservation online and not tying up the call center resulted in savings too. Special members-only pricing encourages customers to purchase the annual \$9 Fare Club membership for \$59.95. Other a la carte fees are linked to conveniences such as seat assignments, bigger seats, and snacks during the flight. But Baldanza and his crew of ancillary revenue converts would quickly learn carry-on baggage fees were a very different animal.

Senators target Spirit Airlines carry-on fee

That’s the headline chosen by CBS News eight days after Spirit announced its carry-on fee on 6 April 2010. Reporters read the 1,030-word press release and picked out one number: \$45. What followed were days of sensational headlines that took carrier management by surprise. With unusual rapidity, the US Congress moved to save consumers from the risks associated with free enterprise. US Senators Ben Cardin of Maryland and Mary Landrieu of Louisiana introduced legislation called the "Free of Fees for Carry-On Act."⁴ The fees were labeled a "slap in the face to travelers" by US Senator Charles Schumer of New York. The fee pandemonium quickly spiraled out of control as members of Congress, bloggers, media pundits, and even the USA Today editorial board vilified Spirit.⁵

However, a careful reading of Spirit’s press release revealed a surprising detail - - no fees would be assessed for carry-ons that fit under a passenger’s seat. Larger carry-ons requiring stowage in the overhead bin would be assessed a fee ranging from \$30 (when paid online or at the counter) to \$45 at the departure gate. Perhaps the press release was written too carefully in an attempt to bury the new fee amongst other news items. Baldanza admits the message strategy was part of the problem, “I think the \$45 price point hurt us, we should’ve focused more on operational issues, which needed a solution that no other airline was willing to solve.”⁶ What was missing from the national discussion was the harsh reality of too many carry-ons clogging up the boarding process. Spirit had tracked the problem and found gate agents and flight attendants were checking an average of 17 bags per flight because overhead bins were filled. That’s an operational mess that benefits no one, especially frequent travelers (those who often pay the highest fares) who get tired of waiting while the crew sorts out the confusion.

⁴ “Senators Target Spirit Airlines Carry-On Fee” article dated 14 April 2010 at CBSNews.com.

⁵ “Our view on air travel: Spirit's carry-on fees add new hassle for fliers” 13 April 2010 editorial, USA Today.

⁶ Ben Baldanza, CEO of Spirit Airlines, IdeaWorks interview conducted 29 November 2011.

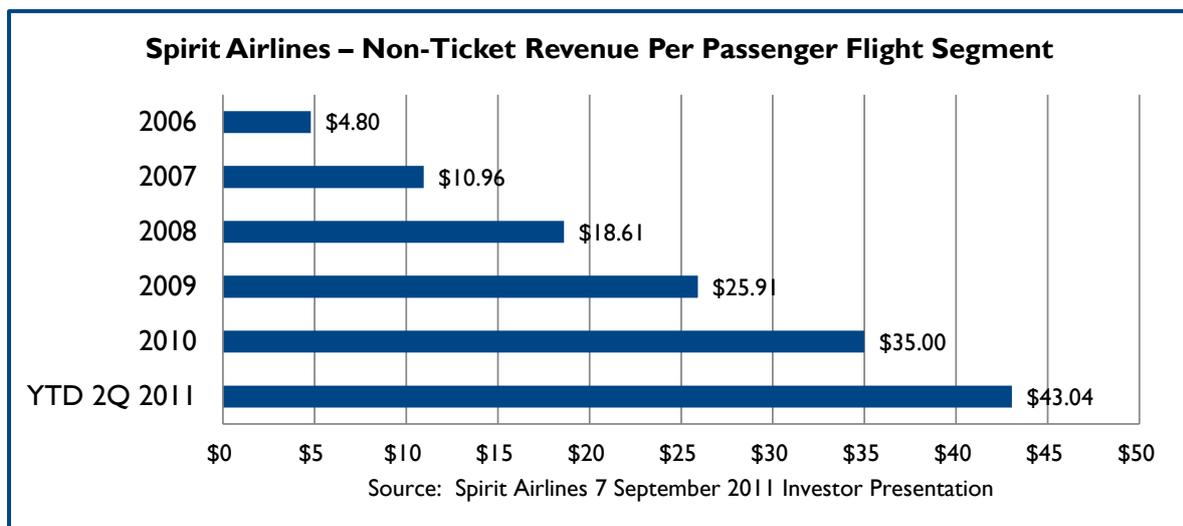
The craziness reached a fever pitch when Senator Schumer announced he had brokered a deal with five airlines.⁷ Yes, a member of Congress did something that many would call price fixing if practiced by a couple of corporate executives. The senator said he personally contacted officials at American Airlines, Delta Air Lines, JetBlue, United Airlines, and US Airways. Commitments were secured from all five companies to put the brakes on airline fees. “I am pleased some of the major carriers have responded to our efforts and have agreed not to charge for something that has always been free.” Congress had indeed acted and most believed Spirit would lick its wounds, lament the error of its ways, and eventually bow to consumer pressure and cancel the fee. More than a year later, passenger traffic and revenue results have proven the skeptics wrong.

Ancillary revenue is in the DNA of this airline

Spirit adapted Ryanair’s aggressive a la carte style to the American market. The major distinction is the addition of the Free Spirit frequent flier program, which satisfies a consumer thirst for mileage accrual and reward travel. The following lists the ancillary revenue activities (which the carrier calls non-ticket revenue) disclosed in Spirit’s 2010 registration to sell shares:

- Charging for baggage.
- Passing through all distribution-related expenses to consumers.
- Charging for premium seats and advance seat selection.
- Consistently enforcing ticketing policies, including change fees.
- Generating subscription fees from the \$9 Fare Club ultra low-fare subscription service.
- Deriving brand-based fees from proprietary services, such as the Free Spirit frequent flier program.
- Selling itinerary attachments, such as hotel and car rental reservations through the website.
- Selling products in flight and generating revenue through onboard advertising.

The following chart lists the non-ticket revenue disclosed by the airline since 2006:



⁷ “Schumer: Several airlines vow not to charge for carry-on bags” article dated 18 April 2010 at CNN.com.

It's not surprising the carrier takes a rigorous approach to ancillary revenue. All catering is non-perishable. Catering truck delivery points are limited to certain cities to reduce handling expense and galley ovens are removed as a cost-cutting measure. The lack of hot and fresh food on Spirit's 6-hour flights between Fort Lauderdale and LAX and to Lima, Peru, certainly encourages travelers to pack sandwiches in their carry-on bags.



Double duty. These bins hit the jackpot with revenue from advertising and fees for roll-on bags.

Spirit departs from the purity of Ryanair's all-economy cabin philosophy with its simply named "Big Front Seat" product. The carrier at one time offered a traditional business class service with dedicated check-in, free drinks, wide seats, and a cabin curtain. However, when this became at odds with management's low cost epiphany, the carrier tried to drop it. According to Baldanza, the cost of reconfiguring the aircraft was an impediment. So business class was remade to conform to Spirit's ultra low cost model. The Big Front Seat became just that - a wide leather seat and nothing more . . . no drinks, early boarding, special check-in, or even checked bags. Even on Spirit, there is a sufficiently sized pool of customers who will pay a premium to sit up front. Upgrades are offered during the flight for those in the back who ask themselves, "Why am I not in that seat?" The service has survived, which is proof of

financial success; Spirit doesn't keep flights or fees that don't make money.

**welcome to spiritair.com,
where \$100 sodas don't fly.**

Many airlines offer a "complimentary" in-flight beverage - but did you know that their average fares are more than \$100 higher* than ours? Sounds like an awfully expensive soda to us.

We're able to keep our fares so low because you only pay for the [optional services](#) you want. When you fly with us, you're welcome to purchase a soda onboard ... but it sure won't cost you \$100.



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[No thanks, take me to spiritair.com](#)

*Average system fares based on year-end 2008 USDOT fare data, SEC filings of roundtrip fares on other carriers, and internal Spirit Airlines fare data adjusted to equalize the carriers' average trip length with Spirit.

Baldanza revealed why the carrier embraced a new perspective a few years ago, "We decided to only compete on price, no one else does this, other airlines always compete on service - - such as free bags." When price becomes the product, the marketing strategy is made crystal clear. It requires the airline to strip all unnecessary costs and sell a basic airline seat at the lowest fare. Travelers quickly learn to adapt to Spirit's methods - - or simply don't return. Strict adherence to the business

model prevents the airline from chasing every customer. Business travelers not seeking the perks provided by other airlines are enticed by Spirit's low fares. The carrier boasts a core following of customers that find Spirit's minimalist approach and Fort Lauderdale hub very appealing.

Surprise, surprise, there is no carry-on chaos

The first day for the new carry-on bag fee was 01 August 2010. According to Baldanza, “On July 31 (the last day with no fee) 60 to 70 percent of our customers carried large roll-on type bags that required overhead bin stowage. Like a knife edge, this dropped to 15 percent on the first day of the new fee.” Senior management was present at airport locations on August 1 to demonstrate support for employees and to personally observe operations. According to management, it was an uneventful day. The airline blanketed consumers with advance emails, described the policy at the website using pop-up messages, and fully prepped its customer contact staff.

If you are looking for chaos at Spirit’s airport facilities, or onboard its aircraft, you’ll be disappointed. Management credits improved airport and aircraft operations as outcomes of the new fee. Flight attendants report passenger boarding and unloading occurs far more quickly. This preserves Spirit’s desire to keep ground time at a minimum. Aircraft in the sky produce revenue; those on the ground do not. Even airport agents, those charged with keeping order, report the vast majority of passengers understand the policy. Of course, there are passengers who are angry and upset with the fee. However, observations made by IdeaWorks at airport locations and onboard a flight did not reveal more traveler angst than found at other airlines.

The secret seems to be broad fee communication and consistent adherence to the policy. Spirit educates consumers at the earliest possible moment and works to avoid customer surprises. The carrier has consciously created a financial incentive for consumers to pay bag fees while booking and before arrival at the airport. The booking process is interrupted by a message (see below) that clearly communicates Spirit’s baggage policy.

Purchase your bags

Buy your bags now and **save at least \$10 per bag** compared to paying at the airport.

FREE OF CHARGE	FOR PURCHASE	
 Personal Item 16 x 14 x 12" (40 x 35 x 30 cm) Must fit underneath a seat. One per person. For instance: Purse, small backpack, briefcase etc.	 Carry-On¹ 22 x 18 x 10" (56 x 46 x 25 cm) Must fit in the overhead bin. One per person. Includes Priority Boarding. \$10 discount for \$9 Fare Club Members.	 Checked Bags Size: 62 linear inches Weight: 40 lbs (158 cm / 18 kg) (linear = length + width + height) Discount for \$9 Fare Club Members.

The carrier honors consumer choice by using an opt-in strategy for carry-on and checked baggage. Email confirmations sent to customers indicate checked and carry-on baggage status and solicit the customer to prepay. Consumers might not like the fees, but the abundance of advance notice effectively prevents any claim of “bait and switch” tactics. The carry-on fee does become progressively more costly if the traveler equivocates. During booking the carry-on bag fee is \$30 or \$35 if paid during online check-in. Waiting until the day of departure becomes more costly with a \$40 fee at the counter and \$45 at the gate. Payment at the gate is limited to credit cards with no cash accepted.

American travelers have it easy, with bag-sizing devices mostly gathering dust from non-use near counters and gate areas. Passengers flying Ryanair and easyJet know all too well that bags must meet the scrutiny of a metal frame before a carry-on is allowed to pass. Spirit has adopted a rigid consistency that would bring a smile to the face of Michael O’Leary, the CEO of Ryanair.

Airline staff are conditioned to monitor passenger baggage at each step of the airport process. Passengers skipping check-in will be stopped by a gate agent prior to boarding. Often, security screeners will offer a helpful hint to travelers by suggesting they return to the counter to check a non-compliant bag. The last line of defense is the flight attendant at the door of the aircraft. However, unpaid carry-on bags rarely make it down the loading bridge. The airline will deny boarding to a passenger who refuses to pay the fee.

Baggage sizing devices offer great clarity and allow travelers to instantly discern between “free” and “\$40” at check-in. The baggage sizing compartment labeled “free” does indeed provide no-fee passage for carry-ons that fit under a passenger’s seat. In effect, Spirit does permit free carry-ons; it simply charges for the largest items. Passengers do try to stuff duffel bags and large backpacks into the free compartment. Agents diligently monitor bag sizes and will charge the fee if the bag is too large or exceeds the top edge of the free compartment.



Fee or free? The compartment on the right provides free passage for carry-ons that fit under a passenger seat. A typical roll on bag (as shown) only fits in the \$40 compartment.

Paying the carry-on fee entitles a traveler to early boarding. That’s the clever operational trick Spirit uses to implement its carry-on fee. Travelers paying for the service receive group one boarding; which is limited to those who have paid the fee. It’s an attractive benefit that guarantees these travelers have maximum access to overhead bin space. Boarding continues for remaining passengers - - who are not struggling with the usual armloads of roll-ons, duffel bags, and backpacks. But beyond the operational benefit of a smoother boarding process, Spirit also realizes attractive revenue from its carry-on policy.

Baggage revenue has jumped since implementation

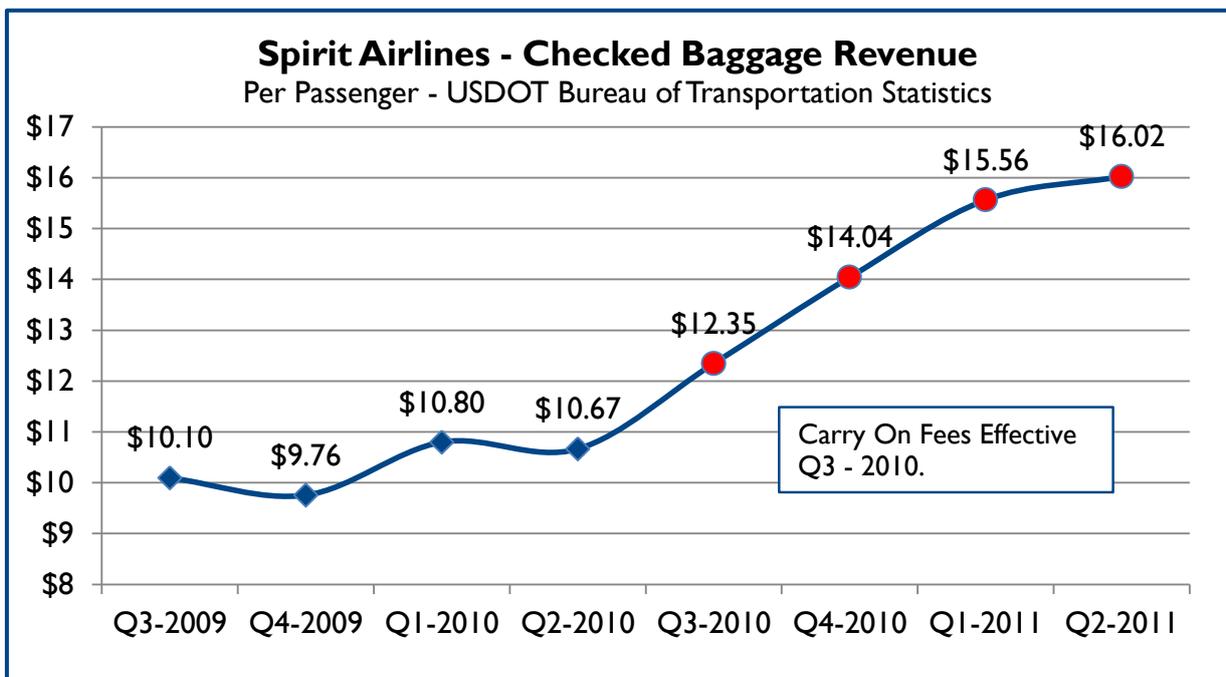
Spirit's passengers faced a new choice on 01 August 2010. They could travel light with no checked bags and take a personal item, such as a small backpack, as a carry-on.

Alternatively, they could check a bag with fees starting at \$25 for the first piece or pay for a larger carry-on with fees starting at \$30. All travelers undoubtedly sought to avoid paying the \$45 fee at the gate. The table below displays Spirit's fee structure from August 2010 (when the carry-on fee became effective) through today. Members of the carrier's \$9 Fare Club have access to lower baggage fees, and fees for international flights are usually higher.

Spirit's Bag Fees – Then and Now				
	Booking	Web Check-in	Airport	Gate
Carry-On (August 2010)	\$30	\$30	\$30	\$45
Carry-On (December 2011)	\$30	\$35	\$40	\$45
1 st Bag (August 2010)	\$25	\$25	\$25	\$45
1 st Bag (December 2011)	\$28	\$35	\$38	\$45

Source: Spirit press release dated 06 April 2010 and review of carrier website December 2011.

The carrier introduced a new fee structure during April 2011 to encourage online pre-payment 24 hours before departure. This is a smart business move that provides economic incentive for consumers to self-serve using online resources instead of using the staffed check-in counter at the airport. The carrier has not felt compelled to reduce its carry-on bag fee, which is an indication of the initiative's success. But the ultimate proof is provided by the steady increase of overall baggage revenue since the fee was introduced during the 3rd quarter of 2010.



Average per passenger baggage revenue has increased from \$10.67 prior to introduction of the fee to \$16.02 for the most recent quarter, as reported by the US Department of Transportation. IdeaWorks believes 20 percent of passengers now opt to pay the carry-on fee compared to the carrier's disclosure of a 15 percent rate when the carry-on fee policy went into operation. Checked baggage activity likely dropped when the carry-on fee was implemented as passengers chose to limit their baggage expense to a single bag . . . be it a carry-on or checked piece.

Revenue associated with checked bags has likely recovered and now nearly matches early 2010 levels. From a revenue perspective, IdeaWorks estimates the carry-on bag fee delivers approximately \$13 million per quarter, or more than \$50 million in new revenue annually. While the fee might be controversial, the bottom line result has rewarded investors and permitted the low cost airline to grow and add more destinations.

Spirit offers the freedom to choose

Airline executives are likely asking themselves, "Would this fee work at my airline?" It's not an easy question to answer. Browsing online consumer comments for Spirit yields an almost endless supply of often vicious and angry commentary about the airline. However, the same spleen-venting can be found for practically all airlines. Spirit is by no means innocent when it comes to choosing profits before customers. The carrier's often-abrasive



Imagine the CEO of Lufthansa doing this. Spirit's CEO goes on YouTube (and in an overhead bin) to take his message direct to the public during the video's self described "carry-on bag crisis."

style practically begs critical comment from consumer activists, travel reporters, and politicians. They might not want to hear the news, but Spirit has proven the financial and operational rewards of carry-on bag fees. Competitors should proceed with caution, as the intangible costs to an airline could quickly exceed any profit opportunity.

But all of this begs the question. What is the measure of a good airline? Some may believe it's

represented by a more forgiving approach to fees and a gentler style of customer service. This blandly describes the majority of airlines in the world . . . and unfortunately, it's a model that fails to deliver consistent profits for investors. By definition, this describes a certain path to failure. Let's next consider Spirit as a definition of a good airline.

Spirit is an airline that is very deliberate in everything it does. When policy specifies a fee will apply, there is no doubt it will be charged. Likewise, when the carrier commits to make a profit for its investors, there is no doubt this too will occur. Ben Baldanza is a CEO who seems to be serving all of his constituents to the best of his ability. Investors have been rewarded with a stock price well above the IPO level. Employees have witnessed growth and stability during challenging economic times. Consumers are benefitting from a low cost alternative in a US marketplace that is rapidly consolidating.

The carrier uses the figures in the following table to make a point. Spirit believes consumers have benefitted from its a la carte approach. While the airline has been reducing its average fare, it has filled the revenue gap with a la carte alternatives. Spirit's average total price of travel from 2006 to 2010 barely increased. During the same period, average US domestic fares went up in excess of 11 percent.⁸ It's a compelling argument that demonstrates the attractiveness of allowing consumers to click and choose their way to a desired level of comfort and convenience.

Spirit Airlines – Fee and Fare Revenue Comparison			
	2006	2010	Change
Average Ticket Revenue	\$104.56	\$77.39	- \$27.17
Average Non-Ticket Revenue	\$4.80	\$35.00	+ \$30.20
Average Total	\$109.36	\$112.39	+ \$3.03

Source: Spirit Airlines, December 2011.

Simply stated, the best airline is one which is financially strong and operationally safe. By these measures, Spirit is an exceptional airline. Baldanza offered this perspective on Spirit's mission, "At our core, despite all the media and governmental pressure that we are bad for consumers, I know we are doing something wonderful for them. We are the most customer friendly airline out there because we give them the power to make the pricing decisions themselves."

This brings us back to Professor Skinner and his theory of behavior modification. The airline will continue to enjoy success if consumers feel their patronage is rewarded with low fares. Spirit's customers "do the math" every day when they buy at Spirit.com. They undoubtedly believe Spirit's combination of "fare and fees" offers better value than other airlines. Failing companies serve fewer customers . . . successful companies attract more. While Spirit's model is working very well for its investors, employees, and customers - - despite what the skeptics and naysayers have said - - it is just one of many potential models to create a loyal customer base in the airline business. The magic lies in the ability to unlock great profit margins from the model your airline uses.

⁸ Annual Round-Trip Fares and Fees: Domestic data (not adjusted for inflation) reviewed December 2011 at Airlines.org.

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- Moving to Merchandising Methods in the Cabin (90 minutes)
- Airline and Hotel Fees: Wicked, Good, Misunderstood? (75 minutes)
- Allegiant Air: How to Be Better Than Ryanair (60 minutes)

Frequent Flier and Loyalty Marketing:

- Loyalty by the Billions (60 minutes)
- Solving the Reward Availability Problem (60 minutes)
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