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The Fate of Ancillary Revenues in the New Fuel Environment
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Once again, the price of jet fuel has radically altered the operating landscape for all airlines. The abrupt decline in the price of crude oil (from a high of $147/barrel in July to around $70 at the end of October) is proving as disruptive to both low cost carriers and the big legacy lines as the meteoric rises the industry had endured over the past few years. While at first blush this development seems to clearly benefit airlines- providing much-needed fixed expense relief after a protracted period of razor-thin margins – there are a few factors at work in this current environment which make the situation a bit more complex. In fact, the fuel price reprieve is, for many airlines, a false comfort due to unfortunately timed hedge contracts. Also, as the slide in oil prices has been widely attributed to the worldwide recession, the decline in fuel costs in being accompanied by similar decline in demand.

In this increasingly fuel-defined landscape, what role will ancillary revenues play? Will a more wary travelling public feeling the pinch of recession avoid ancillary offerings as a way to save money? Or will they flock to LCCs, heightening the importance of ancillary revenues to the overall industry? For the legacy airlines' part, will they seize upon the decline in fuel prices as an opportunity to discontinue ancillary revenue development initiatives, including some of the 'unbundling' fees that encountered resistance last spring and summer (like checked bag fees or fuel surcharges)? Or is the combination of volatility among expenses, reductions in capacity, and steady softening of gross seat sales leading the industry toward a more ancillary-dependent future?

First of all, today's fuel situation has a much more positive impact on low cost carriers- which employ ancillary revenue development strategies both wider and more effectively than their legacy counterparts - for two main reasons. LCCs, by their very nature, have narrow, streamlined cost structures which are affected more visibly by the change in any one major expense. So, if fuel prices can be blamed for the demise of a handful of LCCs in late 2007 and 2008, $70 crude can also be attributed to their current relative health. Secondly, low cost and midsized carriers largely avoided the outsized fuel hedging contracts that are now plaguing the legacy airlines, many of which could not forecast the current drop in prices and are now stuck with contracts for as much as $4.25 for a gallon of Jet-A fuel (the current market price for Jet -A is around $2.00). United, Delta, and US Airways all posted losses for the third quarter that would have been profits were it not for their hedging contracts (1). Hedging, which gained a lot of attention earlier this year when Southwest and other lines looked prescient for locking in before oil broke the $100 barrier, now seems to have erased the gains made by trimming capacity and increasing ticket prices.

Airlines are looking to make up that shortfall, and they are turning to ancillary revenues to serve that purpose. Legacies might be tempted to give back some of the fees that were imposed at the beginning of the summer travel season- and will likely have to abandon fuel surcharges in the face of consumer awareness- but are finding that the ancillary revenues derived from such fees are too important to forego. The web-based ancillaries, like hotel booking and car hire, are secure as low overhead, well-perceived profit centers.

Ancillaries of all kinds are becoming increasingly important as demand begins to dry up with the deepening recession. In the US, the Department of Transportation reported that system-wide traffic was down 0.8% for the first seven months of 2008 (2) (which doesn't even include the last three months of economic mayhem, which will almost certainly be reflected in next quarter's report). Declining demand has the potential to trigger a fare war, though with the plague of hedge contracts among legacies and the generally narrow margins among LCCs, this would be destructive. Rather, LCCs and legacies alike are placing more emphasis on their ancillary initiatives to maximize the revenue earned per passenger. Loyalty programs are also being utilized in new and innovative ways, including tertiary extensions and givebacks like Continental's checked-bag-fee waiver for both frequent fliers and credit card holders (3) , as well as substantial new program development, like Privilege Outlet from Airsavings.

Soft demand also highlights the position of LCCs in the overall air travel market, as leisure travelers that do end up flying increasingly seek the absolute lowest fare available. Legacy airlines trimmed capacity over the late summer and autumn months in an effort to maximize load and prop up fare prices, only to be undermined by the larger troubles of the worldwide economy (and unsuccessful at increasing load factors: the DOT also reports a decline in overall load, from 80.7% to 80.1% (4)). LCCs, by contrast, are well positioned to capitalize on price sensitivity, and have consistently bested the legacies in terms of load without drastic capacity cuts. LCCs will certainly feel the effects of the worldwide recession, but thanks to a bargain-seeking market, perhaps not as acutely as their legacy competitors.

Ultimately, ancillary revenue development has ingrained itself as a key aspect of nearly every airline's core operating strategy, and is unlikely to lose its status now. In fact, the volatility of the marketplace- in terms of both expenses and sales, supply and demand- virtually assures the continued prominence of ancillary offerings. Low cost carriers, the pioneers in ancillary revenue development, must continue to innovate and explore new options apart from the basic airplane seat. Legacies must continue to unbundle where possible and develop new ancillaries of their own. Both need to take advantage of their loyalty programs, and devise new ways to address the slacking of global demand, without resorting to price wars or rampant consolidation. And for that ancillary revenues will almost certainly be the foundation.

1. http://www.bloomberg.com/apps/news?pid=20601103&sid=a8k_UtmG5HE8&refer=news
2. http://www.bts.gov/press_releases/2008/bts049_08/html/bts049_08.html
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4. http://www.bts.gov/press_releases/2008/bts049_08/html/bts049_08.html