For Airlines, Fees Become Lifelines

BusinessWeek

Friday, September 18, 2009

By: Esmé E. Deprez

With travel demand sagging, charges for checked baggage, food, staff assistance, and anything else carriers can think of are becoming key revenue sources

Just a decade ago, air travel was simple: Buy a ticket, fly.
That model has begun to disappear as many U.S. airlines struggle to adapt their businesses to the recession by finding new revenues. Increasingly, the airlines' goal these days is to have the fare be just one piece of the travel experience and to segment every other aspect, from drinks to baggage, HBO to legroom. Whether it's a fleece blanket and travel-pillow set (US Airways) or extra frequent-flier miles (United), the airline cabin has become a virtual bazaar. And nearly every carrier, low-cost or legacy, is getting in on the action.
"As airlines emerge from just transportation businesses into retail businesses, they need to think more like retail businesses," says Henry Harteveldt, a travel analyst at Forrester Research (FORR). That's why at JetBlue's (JBLU) Web site you can now purchase a $15 "doggie hoodie" for your pooch or a $225 model of a company Airbus A320. Nok Air, a Thai budget carrier, gives those who book online the choice of reserving an extensive menu of Thai dishes for the equivalent of $2.65 each.

Just as Amazon.com (AMZN) tracks purchases and then uses the data to market specific items based on a customer's history, an airline that similarly knows you like to eat a fruit-and-cheese plate on mid-afternoon flights could begin offering that online when you buy your next ticket. Allegiant Air (ALGT), a pioneer in the U.S. unbundling movement, knows that most of its customers are on leisure trips to Las Vegas, Florida, or Arizona. As a result, the company peddles a $79 Pink Jeep tour of Arizona or a 100-page photo book for $59.99 midway through the online ticket-booking process.

A GROWING SHARE OF AIRLINE INCOME

Ancillary revenues—products and services airlines can unbundle from the fare and sell à la carte—are increasingly boosting bottom lines. A leader in the unbundling movement, Dublin-based Ryanair Holdings (RYAAY), reported that ancillary revenues made up nearly 20% of its total revenues in 2008 and outpaced overall revenue growth by a wide margin—35%, vs. 21%. At Allegiant, one of the few profitable U.S. airlines, nearly 23% of total 2008 revenue came from ancillary sources. Worldwide, ancillary revenue totaled $10.3 billion for airlines in 2008, a 345% jump since 2006, according to a study by IdeaWorks, a Wisconsin market research firm. "If it weren't for ancillary revenue, we probably would have seen at least one of the major airlines fall, given the recession," IdeaWorks President Jay Sorensen says. He predicts that in the next five years, "the entire domestic coach travel experience will be very similar" to low-cost carriers as legacy carriers continue to unbundle products and services. While most frequent fliers and those in first class will be exempt, food, checked baggage, staff assistance at check-in, and even paying with certain credit cards for free will all but disappear, Sorensen predicts.

Among the most successful shifts has been the move to charge for checked luggage. American (AMR) led the way in May 2008 with a $15 fee to check a first bag and was subsequently matched by nearly every other carrier. Since then such fees have gone international, with United (UAUA) the latest to announce a $50 charge for a second piece of checked luggage on tickets to Europe and India bought after Sept. 30. Even when good times return for airlines, many analysts say, free checked luggage will remain as distant a memory as the smoking section at the back of the airplane—charging for it is just too profitable. Yet with the fees permanent, consumers could be forgiven for wondering where the new charges might end: Is the U.S. market destined to be dominated by ultra-spartan flights, such as those pioneered in Europe by Ryanair, whose CEO has asked Boeing (BA) to explore installing credit-card-operated toilets? "We will see the airlines continue to explore new services they can use to introduce new ways to help generate revenue," Harteveldt says. "They're just trying to figure out how much is too much, not only in terms of price but also at what point they'll face practical unacceptance from the traveler."

Airlines argue that low fares do not cover their costs and that à la carte pricing represents one of the few options for survival. "An industry that is struggling mightily to find a way to break even has to find other sources of revenue to compensate," says William S. Swelbar, a research engineer at MIT's International Center for Air Transportation and board member of Hawaiian Airlines' (HA) parent. "Passenger fares in no way cover all the costs. We need to find a way to subsidize." He projects that the domestic airline industry will see a revenue drop of $15 billion to $18 billion in 2009 because of weak travel demand. And unless an economic recovery brings a significant revenue bounce to the industry, Swelbar warns, at least one major airline could fold.

SOME FEES WORK, SOME DON'T

Taken too far, however, retail techniques may end up hurting more than they help. For example, USAirways' (LCC) failed attempt to charge for soft drinks and water, which the company abandoned in April, resulted in a loss of market share, Harteveldt says, and obscured the fact that the airline had dramatically improved its operational reliability. The industry declined to follow up on that effort, and nonalcoholic drinks have remained largely free, though US Airways CEO Doug Parker still wonders why hotels can charge extravagantly for in-room water and soda while airlines cannot. Instead of instituting fees on things that are already free, Harteveldt says, airlines would be wiser—and consumers would be more receptive—if they introduced new products and services to enhance existing ones. Offering economy-class customers the option to pay for expedited baggage delivery or security lines, for example, could replace a supplemental fee for having a chair that reclines. "People feel ripped off when airlines look to save at the expense of the customer experience," he says.

Sorensen contends that while it may take time to adjust to the new reality of à la carte pricing, consumers will ultimately benefit. "Fees are not bad if they're properly communicated and adequately priced because unbundling allows consumers to pick and choose what they want," he says. In the past, all passengers subsidized the cost of onboard meals, regardless of whether they wanted the food or not. Today, food costs are borne by those eating it. Charging separate fees also clarifies which products and services fliers value. If people subsequently choose to travel with fewer suitcases, for example, that will also benefit the environment, since airlines would use less fuel. "Properly done, this is a good thing for consumers," Sorensen says of ancillary charges.

While many airlines are working furiously to maximize revenue from every component of air travel, some companies in the premium space view such unbundling as dangerous. Just as luxury automakers package their highest offerings into their top-of-the-line models, many airlines recoil from any initiative that could be construed as "nickel-and-diming" passengers. "We must not hurt our product and our brand, and it's very difficult" to chase new revenue sources, says Patrick Brannelly, vice-president for passenger communications and visual services at Dubai-based Emirates. "To us, the best way to generate revenue is attracting people to our brand who appreciate quality." Emirates and other premium airlines use duty-free sales to generate some extra revenues but say there's little else onboard that could produce money without degrading the brand. That's why courting affluent travelers through a luxury "experience"—and the higher fares that commands—is critical. "Service *is* revenue," Brannelly says.

WHERE À LA CARTE SALES GET TRICKY

Because low-cost carriers market directly to the consumer, almost exclusively through their own Web sites, it is far easier to tack on additional services and products at the time of purchase. Malaysia-based AirAsia X, for example, brought in $2.75 million last year from sales of pre-order meals to passengers on long-haul flights such as London to Kuala Lumpur. That kind of retailing has proved difficult to integrate into computer systems used by travel agents and online sellers such as Orbitz (OWW) and Expedia (EXPE). "It's a wonderfully confusing time in the market, with the tug and pull of à la carte revenue but the difficulty of implementing it," Sorensen says.

Pre- and in-flight sales may not be the only way airlines can boost their ancillary income. A fledgling revenue-development experiment called Privilege Outlet invites customers of its client airlines to buy luxury goods such as designer shoes and sunglasses online at reduced prices. Privilege Outlet client companies—mostly budget carriers in Europe, such as Prague-based Smart Wings and Royal Air Maroc's Atlas Blue—net about $2.40 per passenger purchase. Buyers accumulate points toward the airline's frequent-flier program. "There's a relationship created between the passenger and brand," says Raphael Bejar, CEO of Airsavings, a Paris airline consulting firm that developed the model.

Besides, says Bejar, there isn't much left on the plane to collect revenue on. "Charging for blankets, toilets? These are jokes," he says. "The passenger doesn't see any value in this. If you need to charge for a blanket, passengers will just bring another sweater."