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Assessment of product debundling trends in the US airline industry: Customer service and public policy implications

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A B S T R A C T

This paper reviews product debundling trends that have occurred in the US airline industry. Multiple sources of ancillary fees related to ticketing refunds and exchanges, checked baggage, on-board pets, preferred and/or advanced seating assignments, frequent flyer ticket redemptions, and day of departure standby policies are reviewed. Despite the fact that both low cost and network carriers stress the importance of future ancillary fees in their investor reports, our assessment suggests that these fees will be more broadly adopted by low cost carriers. We anticipate that many network carriers will eliminate ancillary fees, particularly as they begin to recognize how these fees can impact other system performance objectives such as minimizing the number of misconnecting passengers. We estimate that the debundling phenomenon has diluted revenues to the US Airport and Airways Trust Fund by at least 5%.

1. Introduction

The airline industry is fiercely competitive. Since deregulation (which in the US occurred in 1978), the airline industry has faced a series of financial challenges and has struggled to maintain profitability. For example, according to the Air Transport Association, in the first 30 years after passenger deregulation, domestic airline prices fell 41.2% in real terms (2010). Numerous factors have contributed to this decrease, most notably the increased market penetration of low cost carriers combined with the increased use of the internet as a major distribution channel (which makes it easier for customers to find the lowest fares). For example, in 1998, only about 1% of domestic leisure flight tickets were sold through the internet. In 2005, this number was 35% (Brunger and Perelli, 2008).

The first decade of the 21st century was especially challenging for major US airlines. Indeed, faced with increased market penetration of low cost carriers, unprecedented fuel costs, continued security threats post 9/11, health outbreaks (SARS, H1N1), economic recessions and the global financial crisis, it is no surprise that in the first decade of the 21st century, the seven largest US network carriers collectively lost $35.1 billion (US DOT, 2010). We define largest using total number of passengers carried in 2006. However, the seven largest low cost carriers (AirTran, American West, ATA, Frontier, JetBlue, Southwest and Spirit) earned $4.9 B and the seven largest regional carriers (American Eagle, Atlantic Southeast, Comair, Expressjet, Mesa, Pinnacle, and Skywest) earned $5.3 B over this time period. This decade also saw customer satisfaction levels plummet, as passengers faced reduced flight schedules, higher load factors, and long security lines (Carpenter, 2008). From 2001 to 2005, four out of the seven largest network carriers went into bankruptcy (Delta, Northwest, United, and US Airways) and from 2005 to 2011 eight major US carriers went through mergers/acquisitions (America West and US Airways in 2005; Delta and Northwest in 2008; Continental and United in 2010; Southwest and AirTran in 2011).

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These statistics need to viewed with some caution, however, as they only paint a portion of the full story of the structural market changes that have happened over the past decade. That is, although it is true that from 2000 to 2009, the total domestic available seat miles (ASMs) by US passenger carriers dropped by 2.7%, it is important to recognize that domestic ASMs fell by 7.2% whereas international ASMs grew by 12.1% (US DOT, 2010). Further, network carriers – Alaska, American, Continental, Delta, Northwest, United and US Airways – moved much of their capacity from domestic to international markets, reducing their domestic capacity by 23.8% and increasing their international capacity by 7.4%. In contrast, low cost carriers – AirTran, Frontier, JetBlue, Southwest and Spirit – increased their domestic capacity by 103% and began to provide international service[1] (US DOT, 2010). As of 2009, the major network carriers concentrated 62.8% of their ASMs in domestic markets (compared to 70.4% in 2000) whereas the low cost carriers concentrated 96.5% of their ASMs in domestic markets (compared to 99.1% in 2000) (US DOT, 2010). Consequently, as of 2009, Southwest Airlines became the largest domestic US carrier in terms of total passengers (Southwest Airlines, 2009a).

The last decade in particular has been one of the most dynamic periods in airline history, with 2008 being especially challenging due to major economic events occurring outside the airline industry that raised costs and reduced demand. During 2008, oil prices soared to more than $130/barrel (CNN, 2010) and the global economic crisis hit, dropping the Dow Jones market value by 33.8%, the third worst calendar year performance on record (2002, the 15th worst calendar year performance on record, experienced a loss of approximately 18%) (Seeking Alpha, 2009). Further, major airlines had already implemented many cost-cutting and revenue-generating measures during the early 2000s as part of their bankruptcy restructuring and merger processes. However, the large market penetration of the internet, combined with low cost carrier competition, hindered the ability to raise fares to a level that could overcome the "perfect storm" that emerged in 2008: soaring fuel costs followed immediately by plummeting demand. Consequently, "2009 proved to be the worst year on record for US airlines, in terms of year-over-year revenue declines" (Southwest Airlines, 2009b).

In times of crisis, though, innovation often occurs. Indeed, in these authors' opinion, 2009 represents one of the fastest and most wide-spread (and bumpiest) implementations of new ancillary revenue streams in airline history. That is, new ancillary revenue sources including checked baggage, seat reservation fees, and food for sale were introduced in the late 2000s. In addition, many existing ancillary fees including fees for redeeming mileage award tickets, day of departure standby fees, agent-assisted ticketing fees, domestic and international ticketing exchange fees, on-board checked pet fees, and unaccompanied minor fees were increased.

This paper reviews the debundling trends that are occurring in the US airline market and discusses potential policy and customer service implications.

2. Methodology

Several sources of data were used for this analysis. Information pertaining to carriers' products was obtained from airline websites, carriers' contracts of carriage, and reservation agents during the last 2 weeks of May, 2010. All mainline carriers serving destinations predominately in the continental US with annual revenue operating revenues exceeding $20 million were included in the analysis. Using these criteria, Hawaiian airlines as well as American Eagle and SkyWest were excluded from the analysis. An additional low cost carrier, Virgin America, was also included in the analysis in order to examine the product differentiation strategies of a relatively new carrier operating under the low cost model.[2]

In gathering information, discrepancies were found within the same airline website. When these discrepancies were identified, they were resolved by calling airline ticketing agents. In several cases, we were able to further clarify the underlying motivations driving the debundling trends through interviews with airline managers. These interviews underscored the importance of examining current and historic debundling trends in the context of prevailing market conditions. Thus, when interpreting these trends, it was often helpful to include information pertaining to carriers not included in the detailed product assessment analysis.

Due to the many changes carriers are making to their fee structures, it is possible that some of the information obtained from the websites will change rapidly. Nonetheless, a comparative analysis based on this information provides important insights into how different carriers are approaching ancillary revenues and, consequently, enables one to infer likely policy and customer service implications.

3. US airline market characteristics

Before describing how carriers have debundled their products, it is useful to review the current structure of the US airline industry, particularly as it relates to their customer segmentation strategies. Table 1 illustrates key differences between major and low cost carriers. The first six airlines in the table represent major legacy network carriers (sorted by size) that serve a wide range of both domestic and international destinations. All of these carriers participate in well-established alliances that

[1] The other two major low cost carriers noted earlier – ATA Airlines and America West – are not included in this comparison as ATA Airlines ceased service in 2008 and America West merged with US Airways.

[2] Spirit Airlines is another smaller low cost carrier that was considered for analysis, but was ultimately excluded due to the large number of destinations served in the Caribbean and Latin America.