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For Airlines, Fees Become Lifelines

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IdeaWorks contributed information to this article - - see italics.

Just a few years ago air travel was simple: Buy a ticket, fly. But as airlines hunt for new revenues to help them weather the recession, their goal is to make fares just one piece of the travel experience. Whether it's a fleece-blanket-and-travel-pillow set (US Airways (LCC)) or extra frequent-flier miles (United Airlines (UAUA)), the airline cabin has become a bazaar, and the selling has only just begun.

Ancillary revenues—products and services airlines can sell à la carte—are becoming a vital financial lifeline for airline balance sheets amid weak travel demand. That's one reason JetBlue (JBLU) sells a \$15 "doggie hoodie" for your pooch or a \$225 model of an Airbus A320. Allegiant Air (ALGT), a U.S. pioneer in à la carte pricing, knows that most of its customers are on leisure trips to Las Vegas, Florida, or Arizona. So midway through the online ticket-booking process, the Las Vegas-based company offers to create a book of your trip photos for \$59.99.

Allegiant, perhaps not coincidentally, is one of the few profitable U.S. airlines, with nearly 23% of its \$504 million in 2008 revenue coming from ancillary sources. Worldwide, such revenue for all airlines totaled \$10.3 billion in 2008, up 346% since 2006, according to a study by market research firm IdeaWorks. "If it weren't for ancillary revenue, we probably would have seen at least one of the major airlines fail, given the recession," says IdeaWorks President Jay Sorensen.

The trend is further blurring the lines between legacy air carriers and discounters. Sorensen predicts that in the next five years, "the entire domestic coach travel experience will be very similar" to that of the discounters as legacy carriers continue to charge extra for products and services. Food, checked luggage, staff assistance at check-in, and even paying with certain credit cards will incur separate fees, he expects.

Airlines argue that they have little choice: Low fares do not cover their costs, and charging for products and services represents one of their few options for survival. "The airlines have been in negative returns since the days of Orville and Wilbur [Wright]," says Daniel P. Garton, executive vice-president for marketing at American Airlines (AMR). "We need to figure out how to get some new revenue." Historically, fares have played the central role in revenue performance, yet carriers have been savaged in recent years as ticket prices have plunged.

Passengers could be forgiven for wondering where the new charges might end. Is air travel destined to be dominated by ultra-spartan flights, such as those pioneered in Europe by Ryanair (RYAAY)? Michael O'Leary, Ryanair's CEO, has even proposed installing credit-card-operated toilets. Says Forrester Research (FORR) travel analyst Henry Harteveldt: Airlines are "just trying to figure out how much is too much."

THE NEW REALITY

Carriers are learning that some fees are more palatable to travelers than others. Checked luggage is one of the most successful new revenue sources—the top 10 U.S. airlines collected \$670 million in bag fees in the second quarter, a 276% jump from the prior year, according to the Bureau of Transportation Statistics. American led the way in June 2008 with a \$15 fee to check a first bag, and nearly every other U.S. carrier has matched that. Bag fees have migrated to international travel, with many U.S. airlines charging \$50 for a second piece of checked luggage. On Sept. 25, British Airways announced new charges as high as \$97 per one-way flight for travelers who want assigned seats sooner than 24 hours before departure.

While it may take time to adjust to the new reality, consumers could ultimately benefit. With an à la carte approach, fliers will no longer be subsidizing products or services they don't use. Passengers can also expect a more customized experience as airlines track individual preferences. For example, if you typically buy a glass of red wine on evening flights or skip the nonstop to your destination because a layover is cheaper, an airline could recognize those habits. Then the company might ask if you want to pair your wine with a cheese-and-fruit plate or to switch to the nonstop flight for an extra fee.

Fees have not infiltrated many of the long-haul premium carriers, which depend heavily on corporate travelers and others paying lofty fares. Some premium service airlines even view the trend as dangerous and avoid 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, a vice-president at Dubai-based Emirates. That's why courting affluent travelers with a luxury experience—and the higher fares that commands—is critical. "Service," he says, "is revenue."