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## **US Airlines Will Generate Millions from Higher Baggage Fees**

*Despite consumer gripes, fee hikes still bring in more revenue.*

Executives at major US airlines have learned to be wary of the future in terms of passenger demand and the price of jet fuel. 2008 provided a stark lesson in airline economics – don't rely on fare increases to keep pace with escalating oil prices. The evolving economic rebound of 2010 will undoubtedly provide more business and leisure travelers. But growing turmoil in Venezuela, Nigeria, and the Middle East increases the fear of another bout of runaway fuel costs. Airline managers have already identified a solution for these troubles: the magic elixir of baggage fee ancillary revenue. The question is, how long will the magic last?

These fees present a very strange alchemy for airlines. Higher baggage charges deliver more revenue – even when fewer passengers check bags as a result of the fee hikes. No doubt recognizing this, the group of big-5 airlines (American, Continental, Delta, United, and US Airways) all boosted baggage fees during January 2010. Delta (including Northwest) could realize an annual cash windfall of more than \$57 million. IdeaWorks estimates the big-5 airlines will generate new baggage fee revenue in excess of \$117 million annually courtesy of Delta's current fee initiative.

Southwest Airlines, which has positioned itself above the fray by promising “bags fly free,” is a large and vocal holdout. The carrier's current advertising campaign virtually assures it will remain on the sidelines for some time. But if Southwest achieved Delta's per passenger result of \$7.32 from baggage fees, its 100 million annual passengers would contribute \$732 million to the bottom line. Baggage fees have become a major economic experiment. Southwest hopes its consumer-friendly policy will deliver big market share gains. Meanwhile, the rest of the airline industry hopes it is far from the tipping point where fee hikes bring diminishing returns and no longer deliver gushers of money.

### **Baggage Fees Become the New Revenue Lever**

Delta Air Lines announced higher baggage fees on January 11, 2010.<sup>1</sup> The new fees are \$23 for the 1<sup>st</sup> bag and \$32 for the 2<sup>nd</sup> checked bag when paid online. Passengers paying at the airport will be charged \$25 for the 1<sup>st</sup> bag and \$35 for the 2<sup>nd</sup>. Within days, the higher fees were matched by Continental, United, US Airways, and most recently American.<sup>2</sup> The fee paid by the large majority of those checking bags is the airport fee for the 1<sup>st</sup> piece.

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<sup>1</sup> “Delta hikes baggage fees again” January 11, 2010 article in the *Atlanta Journal Constitution*.

## Millions from Higher Baggage Fees Page 2

Airlines find fare increases difficult to implement and this is making a la carte fees an attractive alternative. Fare changes must be filed in thousands of markets, and then there is the pesky task of watching how competitors react. Sometimes the industry marches in lockstep; sometimes airlines take the opportunity to inflict pain on each other in hotly competitive markets. Fare comparisons on shopping sites, such as Expedia and Travelocity, display the unblemished truth of which carrier offers the lowest fare. And major carriers must worry about low cost carriers that invariably ignore industry-wide pleas for saner pricing.

Major airlines now clearly consider baggage fees the holy grail of revenue treasure. It's easier to announce a single nationwide fee increase and avoid the messy details of market-by-market fare hikes. The design of online shopping sites makes these increases invisible to consumers; the price matrix is limited to air fares. For example, Expedia warns, "Prices do not include baggage fees or other fees charged directly by the airline." Consumers may click to learn the a la carte fees charged by individual airlines before booking. It's a situation that benefits the airlines, frustrates the shopping sites, and represents a mystery for most consumers. Carriers have been emboldened by the lack of consumer backlash from prior baggage fee increases.

### Tagging the Baggage Numbers

Public disclosure of airline-specific baggage activity has been limited to revenue reports issued by the DOT and occasional projections made by airline executives during quarterly earnings calls. IdeaWorks has calculated "before and after" per passenger revenue using DOT data from 2007 and 2009. Domestic baggage revenue reported by carriers for 2007 consists of fees paid by travelers for overweight and excess pieces above former free baggage limits.<sup>3</sup> Data from 2009 reflects a robust baggage fee environment which ended free baggage allowances for virtually all passengers. The "Net Increase" column in the table lists the incremental per passenger revenue benefit associated with the implementation of 1<sup>st</sup> and 2<sup>nd</sup> second checked bag fees (compared to the free-baggage 2007 baseline figures):

Examples of Domestic US Checked Baggage Fee Revenue – Per Passenger			
Airline	2007 - 3 <sup>rd</sup> Quarter (baseline)	2009 - 3 <sup>rd</sup> Quarter (after bag fees)	Net Increase (2009 minus 2007)
Continental	\$1.12	\$7.90	<b>\$6.78</b>
Delta (excludes NWA)	\$1.49	\$8.81	<b>\$7.32</b>
United	\$0.52	\$5.86	<b>\$5.34</b>
US Airways	\$0.64	\$7.13	<b>\$6.49</b>

Source: Calculations performed on US DOT (T-100 domestic market report) and baggage revenue (P-12) statistics.

<sup>2</sup> "All Up: American Raises Bag Fees, Matching Price Hike At Other Airlines" January 18, 2010 article in the *Wall Street Journal*.

<sup>3</sup> Based upon an email exchange with a representative of the USDOT on January 15, 2010.

## Millions from Higher Baggage Fees

### Page 3

The different amount associated with each airline reflects differing fee structures for checked baggage, passenger profiles associated with each carrier, exceptions made for elite and premium passengers, and each carrier's diligence in collecting fees from consumers. These numbers depict ancillary revenue generated by baggage fees at a particular moment in time. Greater detail is required (such as the percent of passengers checking baggage) to assess revenue based upon higher fees. Unfortunately, carriers don't disclose how many passengers pay fees to check 1<sup>st</sup> and 2<sup>nd</sup> pieces of baggage. IdeaWorks used disclosures by US Airways to project how much fee hikes affect overall baggage fee results.

### Baggage Behavior at US Airways

US Airways told an audience of airline executives at the A la Carte Pricing Conference (May 2009 in Miami) that it generated revenue of \$116.5 million from 1<sup>st</sup> checked bag fees and \$37.6 million from 2<sup>nd</sup> checked bag fees during 2008. The carrier started charging fees for the 2<sup>nd</sup> checked bag on May 5, 2008<sup>4</sup> and for the 1<sup>st</sup> checked bag on July 9, 2008.<sup>5</sup> The revenue disclosed was divided by the appropriate fee to determine the number of paid bags through the end of 2008. Baggage activity was then compared to domestic US and Latin America traffic totals disclosed by the carrier to determine how many consumers paid for checked bags.

Frequency of Checked Baggage by US Airways Travelers		
Baggage Fee Type	1 <sup>st</sup> Checked Bag	2 <sup>nd</sup> Checked Bag
Period of Analysis	July – Dec. 2008	May – Dec. 2008
Revenue from Fees	\$116,500,000	\$37,600,000
Baggage Fees	\$15	\$25
Paid Bags (Revenue divided by Fees)	7,766,667	1,504,000
US Domestic and Latin America Passengers	25,683,899	30,303,471
% Passengers Checking Bags	<b>30.2%</b>	<b>5.0%</b>

*Source: Calculations performed on revenue and traffic disclosures made by US Airways.*

The analysis reveals just over 30% of passengers paid to check a 1<sup>st</sup> bag and approximately 5% of these passengers also checked a 2<sup>nd</sup> bag. These results reflect the behavior of a largely domestic customer base that tends to rely on carry-ons and rarely checks a second bag. These results correspond to those for American Airlines, which recently disclosed to the *Wall Street Journal* that 25% of its domestic passengers pay to check bags.<sup>6</sup>

<sup>4</sup> "US Airways Amends Checked Baggage Policy" press release dated February 26, 2008 at USAirways.com.

<sup>5</sup> "US Airways Accelerates Business Model Transformation" press release dated June 12, 2008 at USAirways.com.

<sup>6</sup> "All Up: American Raises Bag Fees, Matching Price Hike At Other Airlines" article dated January 18, 2010 in the *Wall Street Journal*.

## Millions from Higher Baggage Fees

### Page 4

US Airways experienced a significant decrease of checked baggage activity after fees were implemented. Doug Parker, Chairman and CEO, noted 15% fewer 1<sup>st</sup> bags were checked and 50% fewer 2<sup>nd</sup> bags were checked after the fees were implemented.<sup>7</sup> The overall decrease was 25% and the carrier credits the drop for better overall baggage handling results.

### Applying the Results to Delta Air Lines

The 30.2% and 5% levels were initially applied to the passenger and revenue statistics associated with Delta Air Lines. US Airways' average revenue per passenger during the 2008 period of analysis was \$5.78, which is lower than the \$7.32 achieved by Delta during the 3<sup>rd</sup> quarter of 2009. The percentage of Delta passengers checking bags was adjusted until Delta's higher revenue level was reached. IdeaWorks believes approximately 29% of Delta's domestic passengers checked a 1<sup>st</sup> bag and 5% checked a 2<sup>nd</sup> piece before the higher fees were implemented in 2010.

The experience noted by US Airways' chairman and CEO indicates an elastic demand curve exists for checked baggage fees. Higher fees result in fewer checked bags; consumers tend to find alternatives to save the expense of checking baggage. But alternative solutions, such as using carry-on space, are not unlimited. Delta's recent announcement raised baggage fees by a minimum of \$5 with separate fees charged for payment online and at the airport. Delta disclosed in 2007 that approximately 25% of bookings are made at Delta.com<sup>8</sup> and this statistic was used to create an overall weighted average for 1<sup>st</sup> and 2<sup>nd</sup> bag fees:

Delta 1 <sup>st</sup> and 2 <sup>nd</sup> Bag Fees (Former, Now, and Calculated Average)		
Baggage Fee Type	1 <sup>st</sup> Checked Bag	2 <sup>nd</sup> Checked Bag
Online Fee (Former → Now)	\$15 → \$23	\$25 → \$32
At-Airport Fee (Former → Now)	\$20 → \$25	\$30 → \$35
Calculated Average Fee (Based upon 25% online, 75% airport split)	<b>\$24.50</b>	<b>\$34.25</b>

Source: Baggage fees described at Delta.com and calculations performed by IdeaWorks.

IdeaWorks believes the higher fees might lead to a 10% reduction of checked baggage activity. This belief is based upon the success of prior increases with the caveat that each new increase advances further into uncharted territory. Consumers may opt to travel lighter or attempt to bring more baggage as carry-ons. This assumption would have 26.3% (down from 29.2%) of domestic passengers paying to check a 1<sup>st</sup> bag and 4.4% (down from 4.9%) checking a 2<sup>nd</sup> bag. The baggage assumptions and calculated average fee were applied to a projection of 90 million annual domestic passengers to generate the results listed in the next table.

<sup>7</sup> US Airways Group, Inc. Q3 2008 Earnings Call dated October 23, 2008.

<sup>8</sup> "Delta.com Offers Global Customers More Online Innovation with New One-stop Travel Shop" press release dated June 21, 2007 at Delta.com.

## Millions from Higher Baggage Fees

### Page 5

Projected Revenue from Delta's New Baggage Fees		
Baggage Fee Type	1 <sup>st</sup> Checked Bag	2 <sup>nd</sup> Checked Bag
Annual Domestic Passenger Assumption	90 million (includes NWA)	
Assumed % Passengers Checking Bags	26.3%	4.4%
Paid Bags	23,670,000	3,960,000
Calculated Average Fee	\$24.50	\$34.25
Projected Baggage Revenue	\$579,915,000	\$135,630,500
Total Projected Annual Revenue	<b>\$715,545,000</b>	
Revenue Based on 2009 Fees and % Checked (Baseline, No Fee Increase)	\$657,900,000	
Incremental Gain from Higher Fees	<b>\$57,645,000</b>	

*Source: Calculations performed by IdeaWorks. Traffic statistics and total revenue includes NWA.*

### Consumers Show Surprising Resilience

Articles in the media, chat board postings, and online blogs offer widespread commentary on consumer dissatisfaction with baggage fees. This anecdotal evidence suggests fees are hated and have been a failure from a consumer perspective. In a recent survey by *Consumer Reports*, "hidden fees" were listed as the top consumer gripe.<sup>9</sup> But the economics of baggage fees tell a completely different story.

Successive fee hikes yielding ever-increasing revenue is the clearest proof of success. Airlines have noted little consumer backlash. John Tague, President of United Airlines, commented in late 2008, "I think that we're seeing very moderate friction on the fees in the unbundling."<sup>10</sup> One year later he was asked if Southwest's position as a holdout from fees has harmed his carrier.<sup>11</sup> He answered, "We're not remotely regretful of our competitive position nor our decision." Mr. Tague continued his point by saying United's load factor in Denver was 85% and Southwest's was 69% for the 12 months ending June 2009.

Clearly, major US airlines have not been timid with a la carte fees. While results vary from airline to airline, all are actively advancing this particular element of the ancillary revenue agenda. Delta has traditionally played the role of reluctant follower and waited until December 2008 before it finally matched the industry with a 1<sup>st</sup> bag fee.<sup>12</sup> However, the carrier has kept pace and has been continually rewarded with ever-higher ancillary revenue on a per passenger basis. The rest of the airline world is watching this experiment.

<sup>9</sup> "Top Gripes: What Bugs America Most" article in the January 2010 issue of *Consumer Reports*.

<sup>10</sup> "UAL Corporation, 3<sup>rd</sup> Quarter 2008 Earnings Call.

<sup>11</sup> UAL Corporation, 3<sup>rd</sup> Quarter 2009 Earnings Call.

<sup>12</sup> "Delta Adds First-Bag Fee but Ends Fuel Surcharge" article dated Nov. 5, 2008 at *New York Times* website.

**Millions from Higher Baggage Fees**  
**Page 6**

<b>Selected Baggage Fee Timeline for Delta Air Lines</b>		
Time Period	Revenue Per Passenger	Prior Fee Event
3 <sup>rd</sup> Quarter 2007	\$1.49	Overweight and excess baggage fees
1 <sup>st</sup> Quarter 2009	\$7.59*	1 <sup>st</sup> and 2 <sup>nd</sup> bag fees introduced
3 <sup>rd</sup> Quarter 2009	\$8.81*	1 <sup>st</sup> and 2 <sup>nd</sup> bag at-airport fees increased
2010 Estimate	\$9.44*	All 1 <sup>st</sup> and 2 <sup>nd</sup> bag fees increased

*Source: Calculations performed by IdeaWorks. Fee event information from news sources and Delta.com.  
 \* Figures include 2007 baseline revenue of \$1.49 from earlier overweight and excess piece charges.*

**Creating a Fee Hedge Against Falling Profits**

The assumptions made for Delta generate an overall per passenger revenue increase of approximately 10% to a projected level of \$7.95 per passenger for 2010 (the inclusion of pre-2008 fees boost this to \$9.44). Delta, American, Continental, and United had similar fee structures before January 2010 with some offering a modest discount for online payment. IdeaWorks applied the Delta assumptions and calculated new per passenger revenue statistics for American, Continental, and United. US Airways already had fees largely in line with the new level and will unlikely see a revenue boost from the January 2010 fee increase.

Based upon 2009 1<sup>st</sup> through 3<sup>rd</sup> quarter results, American, Continental, United and US Airways will carry approximately 192 million domestic passengers during 2010. IdeaWorks estimates these carriers will realize annual baggage fee revenue of \$1.044 billion. Adding Delta's \$715 million to this amount generates total revenue of approximately \$1.76 billion. The "new money" portion of this amount for the group of big-5 carriers exceeds \$117 million.

The US airline industry is unlikely to stop this trend and more tweaking of the fee structure can be expected during 2010 and beyond. For example, fees may vary by distance with higher fees for longer flights. Baggage fees are morphing into a type of "fee hedge" against the threat of rising fuel prices. The industry is acting early to prevent the problems it faced during 2008 when fare increases didn't keep pace with rapidly rising fuel costs. The introduction of baggage fees saved the industry from even greater financial distress during 2008 and throughout 2009. These increases indicate baggage fees will play an even larger financial savior role during 2010.

Corporate hubris may push the industry to some sort of tipping point. Southwest's management (and its investors) should expect and require healthy market share gains from its bold product positioning endeavor, and if that happens, the big 5 will have to pay attention. The big-5 airlines should be wary of believing each fee increase will yield revenue growth. Consumers rightly expect a better product for a higher price. Airlines would be wise to invest money into baggage services through delivery guarantees, frequent flier bonuses, and improved customer service. \$117 million in extra revenue is a number worth remembering, but shouldn't be taken for granted.

## **Millions from Higher Baggage Fees**

### **Page 7**

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