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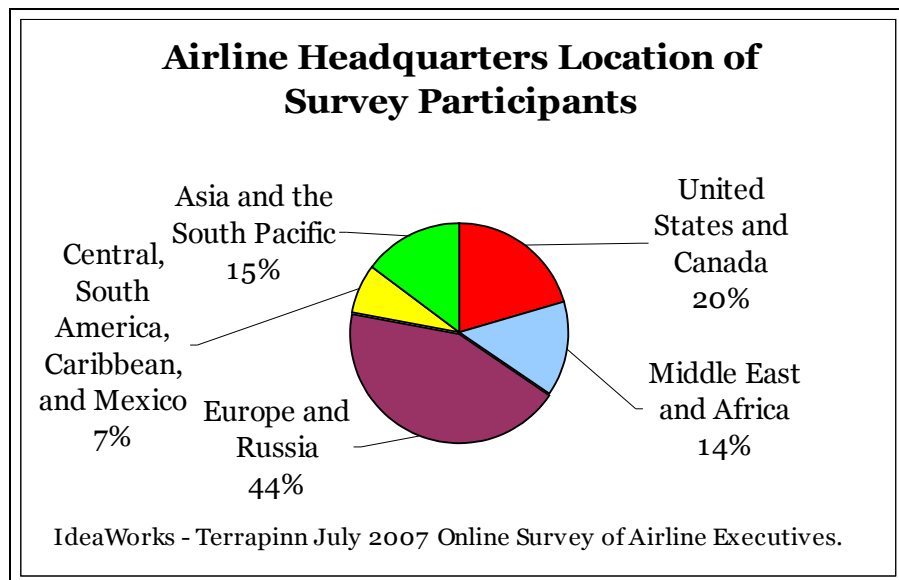
Buckle Your Seat Belts - Airline Executives Predict More Fees and Plan to Sell More Services via Their Web Sites

63% of airline executives in a worldwide survey say charging fees for services - - instead of including benefits in the price of a ticket - - will become more prevalent.

Bette Davis, the two-time Academy Award-winning American actress, once warned a group of passengers to “Buckle up your seat belts because it’s gonna be a bumpy ride.” Today’s consumers might heed her words when contemplating the fees they might be asked to pay in the future for assigned seats, checked baggage, and paying by credit card. Most airlines currently don’t charge extra for these benefits. But survey results suggest airline executives will charge for these, and other services, in the future.

While frequent travelers may consider extra fees a major annoyance, airline executives have another phrase in mind - - they call these fees ancillary revenue. For airlines, this new revenue stream provides welcome relief to fill the gap between rising fuel costs and falling fares. Consumers could benefit from the evolution of all-inclusive pricing, to a process that allows them to enjoy the lowest fare and to add services a la carte.

How far has this practice spread among airlines? What new fees are airline executives planning for the future? To answer these questions, IdeaWorks surveyed airline executives all over the globe.



Ancillary Revenue Trends 2007

Page 2

The survey was distributed online and attracted participation by over 140 airline managers. The pie chart displays the global distribution of survey participants. All regions of the world are represented with 80% of respondents outside the United States and Canada. The survey contained six questions on the topic of ancillary revenue; the response rate per survey item ranged from a high of 142 respondents, to a low of 55 respondents.

What is ancillary revenue?

Unfortunately for the amusement of readers, Mae West didn't offer a quote to define ancillary revenue. IdeaWorks defined the term in an earlier report: "Revenues beyond the sale of tickets that are generated by direct sales to passengers, or indirectly as a part of the travel experience."¹ IdeaWorks further defines ancillary revenue using these categories: **1) a la carte features, 2) commission-based services, and 3) frequent flier activities.** This report focuses on the a la carte category.

Legacy airlines bundle many amenities into the price of an airline ticket. Low cost carriers, and especially those outside the United States, are already un-bundling the travel experience. Under this scenario, consumers purchase basic airline transportation and can choose to pay extra for services such as advance seat assignments, checked baggage and onboard snacks and drinks. This includes the a la carte features and benefits that passengers may purchase before or during their travel experience.

Ancillary revenue activities also include the commissions earned by airlines on the sale of hotel accommodations, car rentals and travel insurance. The commission-based category primarily involves the airline's web site, but it can include the sale of duty-free and consumer products on board aircraft. The frequent flier category is defined by the sale of miles or points to program partners such as hotel chains and car rental companies, co-branded credit cards, online malls, retailers, and communication services.

Unbundling has become more prevalent

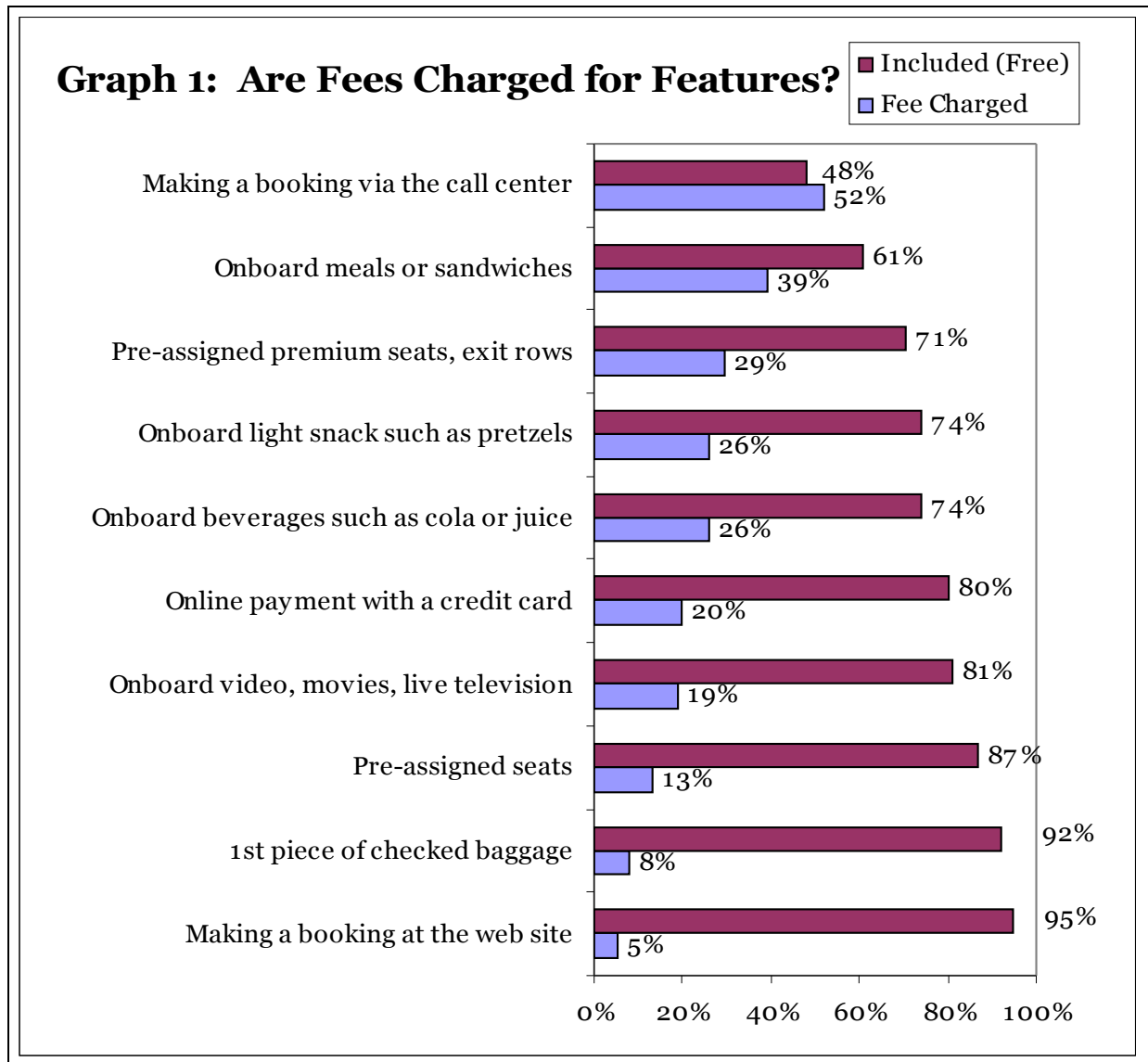
IdeaWorks asked airline executives about industry trends regarding the unbundling and bundling of amenities. The survey results are shown in the table below.

Which best describes current trends regarding charging fees for amenities (product unbundling) in the airline industry?	
Unbundling (charging for amenities) is becoming more prevalent.	63%
No clear trend, some airlines include amenities in the price of a ticket, and others are charging fees for amenities.	37%
Bundling (including free amenities) is becoming more prevalent.	0%

Ancillary Revenue Trends 2007
Page 3

Clearly the industry has embraced ancillary revenue as a pricing strategy. Even more dramatic is the zero level of response to “bundling is becoming more prevalent.” This combination suggests airlines are very focused on a need to boost revenue and cut costs.

Product unbundling is a prerequisite for generating ancillary revenue from service fees. The strong trend toward unbundling demonstrates the growing prevalence of a la carte pricing. But the degree of participation varies from airline to airline. Graph 1 displays the results from the question, “How are features currently provided to your customers; is a fee charged, or is it included in the ticket price?” The survey results provide a picture of how airlines have adopted a la carte pricing and product unbundling.



Ancillary Revenue Trends 2007

Page 4

Features that are candidates for unbundling fall into two categories: **1) expense based or 2) convenience oriented.** Expense-based features incur a meaningful cash cost to the airline. Examples include onboard snacks and drinks, call center bookings, and checked baggage. Convenience-oriented features can be provided to passengers at little or no cash cost. By definition, this category is a bit more limited, and includes pre-assigned seats, early boarding, and boarding passes issued via the web site.

Based upon their appearance at the bottom of the graph, some amenities appear to enjoy a type of “protected status.” Airline executives seem reluctant to charge for web site bookings, checked baggage, and pre-assigned seats. The number of airlines opting to charge fees for these activities is low and only ranges from 5 to 13%. Checked baggage provides an excellent example of an amenity that could easily convert to a la carte pricing. This amenity has clearly defined costs such as added fuel expense and airport staffing. Airlines already have procedures for collecting excess baggage fees.

Airline executives seem to embrace the practice of charging customers for call center support. The 52% survey result reveals this amenity has the highest fee-based penetration of the survey. This practice offers the attractive alternative of encouraging travelers to book via the web site of the airline. But nearly half the respondents indicate their airline continues to provide the benefit without charge.

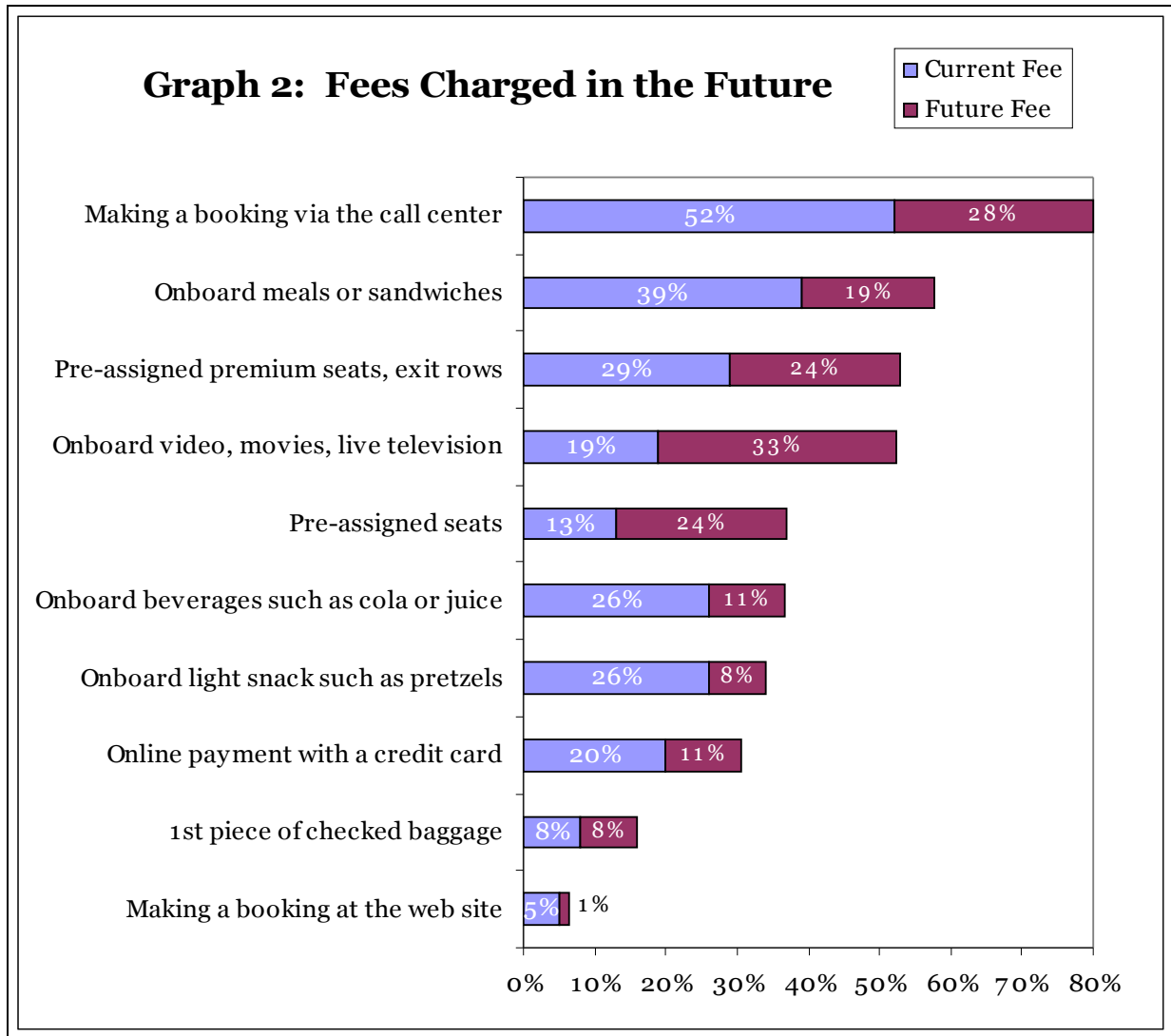
Complimentary airline food, which long ago declined in popularity with travelers, has also declined in popularity with management. It’s the second most popular fee-based amenity among the survey respondents; 39% indicate their airlines sell meals and sandwiches on board aircraft. Prevailing wisdom suggests food quality has improved since the introduction of a la carte pricing. The choices offered on board must be enticing enough to encourage travelers to open their pocketbooks and to skip the temptation to buy food in the terminal prior to boarding.

While charging for pre-assigned seating seems taboo, airlines are beginning to adopt a subtler alternative. Savvy travelers know certain seats on aircraft are better than others. Exit rows offer more legroom and the front rows provide a fast exit upon arrival. 29% of airline executives revealed their airlines now charge a fee for premium seat assignments.

Low cost carriers in Europe may have initiated the practice of assessing extra fees for payments made by credit cards. This reflects a desire to recover the expense of credit card merchant fees paid by the airlines. Of the airlines opting to charge, most waive the fee for payments made by debit cards. The desire to reduce merchant fee expenses has prompted some airlines to offer innovative payment alternatives such as PayPal and even allowing tickets to be charged to mobile phone accounts.

More a la carte pricing is anticipated for the future

Graph 2 displays the results to the question, “Which services might require the payment of fees in the future?” The question included the same list of features associated with Graph 1. The overall result provides compelling evidence of the a la carte pricing trend; every item included in the question showed increased fee activity for the future.



The percentage listed for each item in Graph 2 represents the responses given for current (from Graph 1) and future fees. Adding the two yields a total result for each feature. For example, 80% of survey respondents (52% + 28%) indicate fees are currently charged for call center bookings or are anticipated to be charged in the future.

Ancillary Revenue Trends 2007

Page 6

The results for the call center item demonstrate the continuing shift from a staffed customer service environment to a self-service marketplace. More and more airlines, as evidenced by a total response by 80% of survey participants, plan to pass on the cost of call center operations to the consumer.

An increasing number of carriers plan to generate revenue from existing or planned onboard entertainment offerings. 33% of airline executives, representing the largest “future fee” response, indicated they plan to introduce fees for onboard movies, video or live television in the future. The survey does not clarify whether airlines will convert existing systems to a la carte pricing, or will introduce new services. Ryanair admitted its introduction of fee-based movies failed because its flights were too short in duration. This suggests the feature is more attractive on medium- and long-haul flights.

The sale of meals and sandwiches might also offer greater appeal to travelers on longer flights. The total response rate of 58% indicates complimentary meals, at least in the coach cabin, will become far less prevalent. 19% of survey respondents indicate their airline will start charging for meals and sandwiches in the future. The sale of light snacks, such as pretzels, is likely to be more prevalent on shorter flights. Only 8% of survey respondents indicate they will charge for snacks in the future. The response level the sale of soft drinks roughly mirrors the sale of snacks.

Airline management finds premium seating an attractive ancillary revenue opportunity as evidenced by the increased response rate for charging fees for better seat assignments. 24% of respondents indicate their airlines will start charging for this feature at a future time. Yet, assessing fees for general seat assignments continues to lag among the items included in the survey. Perhaps most airlines wish to preserve the orderly boarding process that occurs when passengers have their seat assignments in advance.

Checked baggage will likely remain an item that continues to be included in the price of an airline ticket. This is surprising because the cost of carrying baggage can be readily quantified by handling costs, lost baggage liability, and added fuel consumption. Plus, passengers already accept the premise that excess baggage fees are charged for overweight items or too many pieces. Only 8% of survey respondents anticipate adding fees for checked baggage in the future. This is in addition to the 8% of respondents who indicate fees are charged today for the first piece of checked baggage.

Future interest seems to be limited for assessing a fee for bookings made via airline web sites. Only 1% of survey respondents indicate their airlines will charge for this feature at a future time. Airlines may be reluctant to charge for a feature that requires passengers to serve themselves. This particular feature may morph into a service charge for live help provided to bookings made via the web site.

Conclusion and observations

The phrase “ancillary revenue” might be new, but the concept of a la carte pricing is well established in the airline industry. PeopleExpress Airlines, which ceased operations in the United States during the 1980s, was ridiculed for charging customers for amenities such as checked baggage and a cup of coffee. Travelers are well acquainted with excess baggage charges and virtually all airlines charge extra for alcoholic beverages. The sales generated from this activity were typically reflected on the income statement under the “passenger revenue” or “other revenue” categories.

So what has changed beyond the words used to describe this activity? What appears to be unique about today’s competitive environment is the eagerness of virtually all airlines - - throughout the world and regardless of classification - - to seek ancillary revenues.

Low cost carriers have clearly chosen to distinguish their product by offering rock-bottom fares and a la carte pricing. Traditionally, major airlines fought this competitive threat by hyping the value of the amenities included in the price of their tickets. Even Southwest Airlines mocks the practice of charging additional fees. Southwest’s recent advertising campaign suggests other airlines have installed coin slots for using tray tables or lowering window shades.

Established airlines face challenging economics that are chiefly controlled by spiraling fuel costs and plunging fares. This dynamic has forced them to consider a la carte pricing. Many have timidly experimented with ancillary revenue methods, while others, such as Air Canada, have fully embraced this new world of airline economics. Even Southwest Airlines has admitted it might consider new a la carte pricing schemes in reaction to moves made by new entrant airlines. The trend is clear, but these conflicting messages do indicate the presence of some unsettled waters.

But there seems to be another element that has supported the ancillary revenue movement - - consumer acceptance. Younger internet savvy consumers, who are unfamiliar with a bygone era of air travel luxuries, happily embrace low fares and the ability to create customized travel through a la carte pricing. The combination of economic need and consumer acceptance, when considered with the survey results described in this report, suggests ancillary revenue has moved from being a fancy phrase to becoming an industry practice.

Ancillary Revenue Trends 2007

Page 8

Sources used in this Industry Analysis: Unless otherwise noted, the survey results described in this analysis were collated from the surveys completed by airline executives. The survey was conducted during July 2007. Multiple surveys (based upon IP address) from any one individual were not accepted.

Disclosure: IdeaWorks makes every effort to ensure the quality of the information in this report. Before relying on the information, readers should obtain any appropriate professional advice relevant to their particular circumstances. IdeaWorks cannot guarantee, and assumes no legal liability or responsibility for the accuracy, currency or completeness of the information.

Endnotes:

1: Europe's Top 4 Low Cost Carriers Generated 470 Million Euros (US\$593 Million) From Non-Ticket Sources in 2005, October 10, 2006, IdeaWorksCompany.com.