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More Airlines Worldwide Choosing Revenue-Based Methods to Serve and Reward Customers

IdeaWorks predicts increased reliance upon a "pay for perks" philosophy for customer services, a la carte features, and frequent flier benefits.

Seemingly unstoppable fuel price increases forced airlines to allow the genie of a la carte fees to escape from its bottle. Even though oil has returned to more normal price levels, airline management can't deny the financial magic produced by ancillary revenue. Many legacy airlines made dramatic changes by implementing fees for services that once were included in the price of a ticket. The relatively high level of passenger acceptance - - or at least lack of a consumer revolt - - surprised carrier management teams. This genie is not going back into the bottle; airlines are changing business models to emphasize customers who are willing to pay for perks.

There is ample evidence that airline marketing initiatives are becoming more revenue aware. Rather than provide free amenities, airlines have learned to "ask for the sale" at every opportunity. A la carte fees are quickly becoming associated with checked baggage, call centre support, and onboard meals. Frequent flier programs are charging more fees and the beloved "mile" is slowly being marginalized by accrual methods tied to ticket prices.

IdeaWorks applied its ancillary revenue expertise, and its contact with airline clients worldwide, to anticipate the growing effect these changes will have on the air travel experience:

- Major carriers in the United States will introduce **more a la carte fees** to broaden the revenue success of checked baggage fees.
- Baggage **fees will spread** to international markets, to include the transatlantic, as more airlines become comfortable with the change.
- Food-for-purchase programs will gain acceptance on longer haul flights, but will begin as offers to **upgrade the dining experience**.
- Mileage-based frequent flier accrual will slowly be **replaced by points** tied to the fare paid by the passenger.
- Likewise, mileage-based rewards will be replaced by market-priced rewards that allow members to spend point balances to **buy reward travel**.

The conversion to a new revenue-aware philosophy has been the most rapid for airline consumers in Europe and the United States. While a la carte pricing was largely conceived by Europe's low cost airline industry, the world's airlines have been avidly watching recent events in the U.S. market. The revenue success realized in these two markets suggests the ancillary revenue movement is about to rapidly spread to the rest of the airline world.

More A la Carte Fees Predicted Worldwide

The gradual unbundling of the air travel experience, and the growing prevalence of a la carte choices, demonstrates the growth of the ancillary revenue movement. Fees associated with checked baggage were once largely used by low cost carriers in Europe such as Ryanair and easyJet. Now these fees have also been adopted by the three largest names in the U.S. airline industry - - American, Delta, and United. Of course, all of this follows an already clear trend by many airlines to charge a flat fee for bookings made via airline call centers.

The fees associated with checked baggage in the U.S. market have been a revenue success story. American Airlines generated $70 million[1] in extra revenue during the 3rd quarter of 2008 from the fees for a first piece of checked baggage. United estimates it will realize $300 million[2] in additional revenue during 2009 from its new baggage fees. Delta was initially reluctant to initiate a fee for the first piece of baggage. However, it will join other U.S. major airlines on December 5, 2008 with a $15 fee for the first piece.

Delta only considered this after its chief operating officer observed, "The increase in bags being carried on board Delta aircraft this year tells us that customers are not differentiating Delta as the only major airline not charging for a first checked bag." [3] He went on to observe that these fees have been "broadly accepted in the marketplace."

Europe's major airlines, and legacy airlines throughout the world, are likely to greet these events with enthusiasm. Lufthansa, SAS, Air France/KLM, and others, are most likely to copy the baggage fees already implemented by low cost carriers on shorter haul flights within Europe. Transatlantic markets represent a future frontier that will require one European or American carrier to make a bold move by being the first to charge fees. The revenue potential of baggage fees suggests it's an inevitable event.

Thus emboldened, legacy airlines will likely adopt the other a la carte fees already charged by low cost airlines. Some of this activity has already occurred. Delta recently matched Northwest's existing practice of offering coach customers the ability to purchase a better seat assignment for $5 to $25.[4] Most surprising is the recent announcement by one of the world's preeminent airline brands; Singapore Airlines just announced a fee of US$50 per sector to reserve exit row seats in its economy class.[5]

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[1] "American, Delta face a downdraft in profit" Los Angeles Times article dated October 15, 2008.
[2] United Airlines presentation at the Calyon Airline Conference 2008 on September 18, 2008.
[3] Delta Air Lines press release dated November 5, 2008.
[4] Delta Air Lines press release dated November 5, 2008.
[5] Singapore Airlines press release dated November 3, 2008.

But this is likely only the beginning of a gradual deployment of a revenue-aware philosophy that allocates services and features to the highest bidder. Low cost carriers have already trod this path and savvy management teams are busy analyzing additional a la carte opportunities:

- Airport check-in at a staffed counter.
- Empty seat between two seats.
- Fast track security screening.
- Mobile phone access.
- Onboard internet and/or email access.
- Online payment with a credit card.
- Online payment with a debit card.
- Priority boarding, early boarding.
- Seat assignments in forward aircraft rows.
- Self-service airport check-in at a kiosk (instead of online).

Major airlines will likely show some restraint now that the price of fuel has fallen to more acceptable levels. However, management teams simply can't ignore the significant revenue gains made by American, Delta, United, and other U.S. carriers. But caution and thoughtfulness are warranted; U.S. airlines have likely moved too swiftly from the full-service model to a la carte methods. Employees, the media, and consumers need to understand and accept these dramatic changes . . . most airlines haven't dedicated sufficient resources to ensure successful product introductions.

Food-For-Purchase and Long Distance Travel

Airline food holds a special position in our travel culture. It has been the subject of derision by comedians, politicians, reporters, and the general public. But woe betide any airline that makes abrupt changes to seemingly minor elements such as free soft drinks, coffee, and peanuts. And as United Airlines recently discovered, the world is not yet ready for the sale of food in economy class on flights between North America and Europe . . . or is it?

United probably regrets the August 20, 2008 news that it was planning to test a buy-on-board concept on transatlantic flights operating at its Washington Dulles hub during the 4th quarter of 2008.[6] Within 13 very unlucky days, the airline said it was compelled by overwhelming public feedback to drop its test plans.[7] Surprisingly, food-for-purchase on long distance flights is already an accepted fact for a number of airlines throughout the world.

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[6] "United Airlines ends free meals on flights" article at the Arizona Republic website on August 20, 2008.
[7] "United Backs Off Plan to Cut Free Meals From Transatlantic Flights" article in the Wall Street Journal on September 2, 2008.

AirAsiaX and Jetstar in the Asia-Pacific market already provide food-for-purchase options on long distance flights. Air Baltic, which operates 5+ hour flights from its Riga hub, has also replaced complimentary food with a buy-on-board café. All three airlines allow customers to pre-order meals, often at a discount, to guarantee the availability of a hot entrée. Air Berlin takes a unique approach with its Sansibar gourmet meals. The airline continues to offer complimentary snacks, meals, and beverages to economy passengers. These customers may "upgrade" their dining experience by ordering a specific gourmet entrée before departure.

Within Europe, the buy-on-board path has also been blazed by Scandinavian Airlines. The carrier offers a basic Economy product on short and medium distance routes that excludes complimentary food and beverages. Consumers may choose to upgrade to Economy Extra, which provides a 3-course meal box and drinks, along with other amenities.

But the biggest news might be the comments made by Willie Walsh, the CEO of British Airways, at the recent World Low Cost Airlines Conference in London. "I think we are only scratching the surface at BA regarding ancillary services." [8] The article also reports British Airways is "even investigating charging passengers extra for the option of an 'upgraded' in-flight meal." While specific routes were not mentioned, the opportunity to purchase a better meal would probably have its greatest appeal on longer flights, such as transatlantic markets.

United's aborted buy-on-board test won't be the last attempt to bring a la carte fees to long-haul flights. Perhaps Ryanair, in its plans to launch low cost flights on transatlantic routes, will nudge others to consider food-for-purchase programs. Or, maybe legacy airlines will take a more careful approach by adding a meal upgrade alternative as a first tentative step.

FFP Accrual and Rewards Will Be Tied to Fares

The ongoing marginalization of "miles" as the prevailing currency for frequent flier programs is more certain than the arrival of food-for-purchase programs on transatlantic flights. This statement may shock many readers - - but the seeds of this revolution have already been planted. The choice of miles is nothing more than an accident of history. U.S. carriers introduced frequent flier programs in the early 1980s; this was also during the time of airline deregulation in the United States.

Airfares were reasonably consistent with the flight distance flown by passengers; miles were a rather decent measure of the value of a customer. Plus airfares were not always captured by early airline reservation systems. The economics of the airline industry have changed completely since the early 1980s. It would be unreasonable to expect the original frequent flier program accrual structure to remain unchanged. Yes, mileage remains the prevailing currency, but significant adjustments have been made along the way.

[8] "Will BA start charging us extra to 'upgrade' meals?" article in The Daily Mail dated September 25, 2008.

Frequent flier programs first awarded miles based upon the distance flown by the member. As pricing became more sophisticated and less tied to distance, subtle adjustments have been made to this simple accrual currency. Many airlines today have introduced methods to modify mileage accrual to better reflect the revenue value of the travel taken by the member. The majority of programs currently use the methods described on lines C and D:

Evolution from Miles/Kilometers to Points
A. Flight Distance Mileage/Kilometer Accrual
▼
B. Class of Service Bonus for Business and First
▼
C. Mileage Variation by Fare Type
▼
D. Distance-Based Points by Fare Type
▼
E. Point Accrual Tied to the Fare Paid

For example, members in Lufthansa Miles & More and Korean Air SKYPASS accrue miles (even though both countries officially use kilometers) based upon ticketing class. The SAS EuroBonus and Qantas Frequent Flyer programs use a point schedule that is linked to the distance flown with an adjustment for different fare types.

The common objective among these methods is for accrual to become more closely aligned with the fare paid by the passenger, and place less importance on the miles flown. SAS clearly states this objective to consumers at its website: *"The principle is simple, the more you spend the more points you earn."*

The same revenue-aware philosophy is beginning to apply to the reward side of frequent flier programs. The revenue management function at airlines has clearly influenced this evolution. Members willing to spend more miles, kilometers or points should have access to more reward seat availability. The prevailing issue is the consumer's perception that not enough reward seats are provided. The revenue-aware solution is to allow members to buy increased reward inventory by spending more miles, kilometers, or points.

Recently launched programs have been free of mileage-flown influence and have chosen to strictly link accrual to the fare paid by passengers. Examples include airlines in the Asia-Pacific, Europe, and Americas regions: Virgin Blue Velocity (launched November 2005), Vueling Airlines Punto (October 2006), and Virgin America Elevate (August 2007).

Standard zone-based awards also remain very popular with airlines all over the world. For example, SAS EuroBonus and Japan Airlines Mileage Bank offer a single capacity controlled reward for each cabin class. The revenue management function is designed to limit reward seat availability to inventory that would normally go unused on any particular flight.

Evolution from Standard to Market-Priced Rewards
A. Standard Zone-Based Reward
▼
B. Standard and Anytime Rewards
▼
C. Tiered Rewards: Low/Medium/High Availability
▼
D. Market-Priced Rewards Purchased with Points

However, more and more programs are using the method described on line B. American AAdvantage and United Mileage Plus offer anytime rewards that are free of blackout dates and capacity-control restrictions. These airlines offer a standard reward at 25,000 miles (for capacity-controlled travel within the United States) and price the anytime reward at 50,000 miles. Anytime rewards always provide a reward seat - - even if it is the last seat available on the flight desired by a program member.

Delta added more complexity on July 30, 2008 by changing to a reward structure offering "low, medium, and high" seat availability.[9] Under this method, the standard capacity-controlled reward has been kept at 25,000 miles, the anytime option is priced at 60,000 miles, and a new medium availability reward has been introduced at 40,000 miles. The overall effect is to offer a spectrum of rewards with mileage requirements linked to relative degrees of seat availability. Alaska Airlines can be credited with first initiating this enhancement; its Mileage Plan frequent flier program announced a 3-tier reward structure on July 24, 2008.[10]

Air New Zealand has taken the reward process to the ultimate level of integrating the worlds of airline pricing and frequent flier programs. The currency used by its frequent flier program is called Airpoints Dollars. And similar to its real world namesake, these are spent just like dollars to buy reward tickets. Simply stated, any seat on any day on any flight can be purchased with Airpoints Dollars. As in buying a seat with cash, the price of seats on off-peak days will be lower than peak periods, such as holidays and summer school breaks. Other carriers offering market-priced rewards include the following: Virgin America, Virgin Blue, and Vueling Airlines.

[9] Delta Air Lines press release dated July 30, 2008.
[10] Alaska Airlines press release dated July 24, 2008.

Under the market-price reward scenario, the toxic issue of seat availability disappears. Members may debate the true value of their points, and complain about not having enough points, but the method makes every seat available for reward travel. But the method offers another important benefit - - it helps prepare a frequent flier program for a possible spin-off. Market-price rewards align investor needs with the expectations of consumers. These benefits will undoubtedly encourage the airline industry to continue the movement to more precise methods of reward allocation.

Being Revenue Aware Provides a Bottom Line Boost

The development of a revenue-aware philosophy has been driven by two factors. First and foremost, nothing has transformed the operating model of major airlines more than the growing presence of low cost carriers. Secondly, the 2008 spike in fuel prices led airlines worldwide in a panic-inspired quest to identify new sources of revenue.

There has been one very noticeable holdout from the rush to add a la carte fees. Southwest Airlines has initiated a high-profile advertising campaign of "No Hidden Fees." Its consumer manifesto lists all the services it includes in the price of a ticket: **No first checked bag fee. No second checked bag fee. No change fee. No window or aisle seat fee. No curbside check-in fee. No phone reservation fee. No snack fee.**

But even Southwest refuses to ignore the success enjoyed by its airline brethren. Kevin Krone, Southwest's vice president for marketing, sales and distribution, concedes the no hidden fee policy could be dropped if deemed to be unimportant, "If customers tell us they don't care or show no preference, we would have to seriously look at our position." [11]

Southwest has taken an admirable pro-customer position, but this might not matter to consumers caught in the global economic meltdown. The inclusion of amenities is probably of greatest importance to business travelers. The seemingly unlimited luxury represented by sleeper suites and the growing popularity of premium economy provides proof that quality is important to a component of the market. But carriers such as Ryanair and easyJet have also proven the inescapable allure of rock-bottom airfares.

Ancillary revenue, a la carte pricing, and a revenue-aware philosophy are all phrases that focus on a single strategy - - to capture the most revenue from every passenger during tough economic times. Building value and amenities into the travel experience has become a competitive necessity to capture business travelers. On the other end of the spectrum, using low fares and embracing a revenue-aware philosophy has probably become an economic necessity to capture price-conscious consumers seeking the flexibility and savings of a basic transportation product.

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[11] "Additional fees apply" article in the Chicago Tribune dated November 3, 2008.

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