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Alaska Airlines' Remarkable Revenue Strategy

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IdeaWorksCompany contributed information to this article - - see italics.

Last week, Alaska Airlines (NYSE: ALK) announced that it would raise its fees for checked baggage, from $20 to $25 for each of a passenger's first two checked bags. The announcement had a palpable impact on the company's stock price: shares rose 7.7% on the day of the news. Along with increasing flight change and cancellation fees, the company estimates that it will increase revenues by $50 million annually.

Alaska Airlines is a leader in ancillary revenue (add-on revenue not included in the basic price of an airline ticket). According to IdeaWorksCompany, an airline revenue consulting company, Alaska Airlines ranked 10th among global airlines in 2012 in the category of Ancillary Revenue Per Passenger. As you may have noticed if you've traveled recently, ancillary revenue is increasingly a favored method by which airlines increase their sales, from charging for baggage, to selling merchandise during flights, to issuing co-branded frequent flyer miles credit cards with major banks.

How much of Alaska Airlines' revenue comes from these ancillary services? The following table shows the relationship between ancillary revenue and total revenue, both for Alaska Airlines, and for four other major U.S. carriers: United Continental (NYSE: UAL) , Delta Airlines (NYSE: DAL) , AMR Corp (NASDAQOTH):

Company		Ancillary Revenue	Annual Revenue	Ancillary Revenue to Annual Revenue	Net Income	Net Income to Annual Revenue
United Continental		$5.30	$37.15	14.27%	($0.72)	-1.95%
Delta		$2.60	$36.70	7.08%	$1.01	2.75%
American		$1.90	$24.80	7.66%	($1.87)	-7.54%
Southwest		$1.60	$17.10	9.36%	$0.42	2.46%
Alaska		$0.63	$4.60	13.63%	$0.32	6.87%

Sources: YCharts, IdeaWorksCompany articles, and author's calculations. All dollar figures in billions.

Alaska Airlines is second only to United Continental in the percentage of total sales that derive from ancillary revenues. Incidentally, this comparison group is not chosen at random: United, Delta, American, and Southwest rank one through four, respectively, worldwide in terms of total annual ancillary revenues in dollars. It's interesting that United derives more yearly ancillary revenue, $5.3 billion, than Alaska's total yearly revenue of $4.6 billion. But, as may be apparent from the table, just having a high percentage of ancillary revenue, or taking home billions of this revenue in a year, doesn't necessarily make an airline hugely profitable. United, despite its high percentage of sales outside of ticketed fares, still lost money last year. Alaska Airlines has the next highest percentage in the table, but it's also by far the most profitable of the group. Does Alaska differ in its approach from other airlines in how it gains ancillary revenues?

Turning a hassle into a benefit

I've previously written about how Alaska's management is tuned into its employee base, and how this boosts profit. Management also understands its customer base, and recognizes that the industry's gleeful rush to tack on "a la carte" fees can backfire -- ancillary revenue to an airline is, in many instances, interpreted as an upcharge or hassle by flyers. Ingeniously, over the last five years (since following other airlines and introducing fees for checked baggage), the company has turned the hassle of baggage fees into an incentive for customers, by introducing its "Baggage Service Guarantee" program, or BSG. While the company charges the now-raised fee of $25 for a traveler's first two checked bags, it also guarantees that the bags will be delivered to the customer within 20 minutes of the flight's gate check-in. If the airline fails in this promise, flyers can request a voucher that is good for a $25 discount off an Alaskan flight in the future, or 2,500 miles in the company's "Mileage Plan" frequent flyer program.

The IdeaWorksCompany reports some interesting observations about this unique program. First, by forcing itself to perform in delivering baggage to customers, Alaska Airlines started using metrics in order to track and improve, and it had a real incentive to do so. The company now enjoys a truly remarkable success rate in baggage delivery: over 99.9% of its bags were delivered in 20 minutes or less last year. Thus, baggage delivery has evolved from a net cost, to a profit center, due to the attachment of the ancillary revenue and the goal-based performance of the BSG program.

Increasing revenue without alienating customers

Alaska Airlines' approach to its baggage fees is evidence of a thoughtful management team as well as a mini-case study into how ancillary revenue can work for both an airline and its customers. In this case, Alaska turned the pain of a new charge for checked bags into an incentive for customers to choose its airline over competitors. Particularly in the case of business travelers, the BSG lends itself to being perceived as having a greater benefit than cost. And, because the company already has burnished its ability to move luggage on time, most of the $50 million of new revenue will flow straight to that sweetest of sweet spots: the net income line at the bottom of the profit and loss statement. If you follow or are invested in Alaska Airlines, look for similarly nuanced strategies to boost profit through ancillary revenues in the future.