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## **Testing Consumer Patience - Airline Executives Predict More Fees**

*69% 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.*

IdeaWorks, in cooperation with Terrapinn's upcoming World Low Cost Airlines Congress in London ([www.LowCostAirlinesWorld.com](http://www.LowCostAirlinesWorld.com)), has conducted its second annual survey of airline executives on the topic of ancillary revenue and a la carte pricing.

The results are clear: with excess capacity keeping a lid on airfares, more and more airlines are turning to a la carte pricing to provide an ancillary revenue boost. A la carte pricing has become especially prevalent in the USA, where major airlines have made an unprecedented rush to new fees for checked baggage, inflight services, and frequent flier benefits. Airline CEOs are obviously desperate to recover the profits lost to the spiraling cost of jet fuel.

Airlines generally strive to match the airfares of competitors. However, more and more airlines appear willing to act independently on the issue of a la carte fees - - for instance when American was the first major U.S. airline to charge for the first piece of checked baggage. IdeaWorks surveyed 113 airline executives to answer the question, "Where is the airline industry headed in regard to ancillary revenue?" For example, fees for call centre support are tapped out with 81% of airline executives reporting current or future fees. Technology now provides more growth potential. Only 6% currently charge fees for onboard internet and email access, with 57% saying they will add this fee in the future. Last year's survey revealed a growing preference for a la carte fees. This trend continues for 2008 with higher levels of ancillary revenue activity and an even broader array of services and features covered by fees.

Airline executives are more willing to test the patience of travelers as they face the need to collect more revenue from every customer. These moves are not done out of desire, but rather out of necessity.

### **The need for more revenue**

Clearly, the price of oil is fueling an overhaul of the airline industry's operating philosophy. Airline executives all over the world realize they must increasingly rely upon alternative revenue sources. Giovanni Bisignani, the director general of the International Air Transport Association, bluntly assessed the impact of oil in a recent speech, "*After enormous efficiency gains since 2001 there is no fat left and skyrocketing oil prices are changing everything . . . Twenty-four airlines went bust in the last six months and US\$130 per barrel oil is reshaping the industry even as we speak. In the next 12 months we could face US\$99 billion in extra costs from oil.*"<sup>1</sup>

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<sup>1</sup> "State of the Air Transport Industry" speech by Giovanni Bisignani of IATA on June 2, 2008.

## **Airline Executives Predict More Fees**

### **Page 2**

Individual airlines are eager to cite the price of oil as the major factor when making strategic decisions; this rationale may be regretted as the price of oil falls. US Airways recently announced a broad array of changes under the title of its “Business Model Transformation.”<sup>2</sup> Under this initiative, the carrier reduced domestic capacity, reduced employee headcount, and implemented new ancillary revenue activities. The airline focused on the high cost of fuel as the primary force working against profitability by offering the following evidence in its June 2008 announcement:

- The cost of jet fuel has increased more than 90% over the last 12 months (and more than 200% since 2000).
- US Airways estimates its total annual fuel expense will be \$1.9 billion more in 2008 than it was in 2007.
- In 2008, fuel represents 39% of total expenses; in 2000, fuel represented 14% of the airline's total expenses.

The most compelling fact was saved for last. *“At current fuel prices, US Airways will spend an average of \$299 in fuel costs alone to carry one mainline passenger on a roundtrip journey, which is up from an average of \$151 in 2007, and \$70 in 2000.”*

### **The ancillary revenue option**

Consumers seem to understand the need for airlines to generate more revenue during these times of spiraling fuel prices. However, airline customers question the rapid onset of fees as a method to deliver profits; they often suggest airlines should simply raise airfares. Airlines around the globe would undoubtedly prefer the immediate gratification provided by airfare increases. Fares have been slow to rise and airlines have relied upon the less-transparent method of fuel surcharges. But more and more carriers are choosing ancillary revenue as an important step on the path to profitability.

IdeaWorks believes two primary factors are encouraging airlines to try ancillary revenue. First, raising fares is not so easy in a travel market that is facing declining demand due to tough economic times. Simply said, in many regions of the world, too many airline seats are chasing not enough passengers. IATA recently rang the alarm bell when worldwide passenger growth for June of 2008 dropped to a 5-year low, *“Although the passenger demand grew by 3.8%, this is the slowest growth that we have seen since the industry was hit by the SARS crisis in 2003. With consumer and business confidence falling and sky-high oil prices, the situation will get a lot worse.”*<sup>3</sup>

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<sup>2</sup> “US Airways Accelerates Business Model Transformation” press release issued by US Airways on June 12, 2008.

<sup>3</sup> “Freight Volumes Contract and Passenger Growth Hits Five-Year Low” press release issued by the International Air Transport Association (IATA) on August 4, 2008.

## **Airline Executives Predict More Fees**

### **Page 3**

It's impossible to achieve across-the-board fare increases in a market with weakening demand and too much capacity. Airlines worldwide have been addressing the supply issue with capacity reductions; carrier bankruptcies and shutdowns have also removed seats from the market. But these changes have not yet created a stable environment in which airfares can increase to levels that cover the cost of providing transportation.

IdeaWorks believes "reluctant consumer acceptance" is the second factor contributing to the rise of a la carte fees. Carriers have been implementing new fees because a dramatic consumer and regulatory backlash has yet to occur. Low cost carriers in Europe have successfully relied upon a la carte fees for many years. Consumers love to bash Ryanair and its aggressiveness on charging fees and yet the carrier's consistent traffic growth indicates acceptance. Success breeds success and non low cost carriers, to include airlines outside of Europe, increasingly turn to ancillary revenue methods.

More and more traditional airlines now charge fees for services that were once free. Scandinavian Airlines sells food to its economy passengers on flights within Europe. Aer Lingus passengers pay for beer and wine on long haul flights. Air New Zealand charges a fee for reservations made via its call center. Passengers on American pay a fee to check baggage on domestic US flights. Lufthansa has implemented a Ticket Service Charge for tickets issued at its call centre, airport counters and website.

United recently made a bold move to test a buy-on-board concept on its transatlantic flights. Economy-class passengers will not receive complimentary meals on flights to and from Washington Dulles during the 4<sup>th</sup> quarter of 2008.<sup>4</sup> This latest move could stir resentment from passengers and United's already unhappy employees. Surprisingly one consumer advocacy group may have already accepted this particular change, "*This is the new era of a fee for every service. We should get used to it,*" said David Stempler, president of Air Travelers Association.<sup>5</sup> A multitude of indicators suggest airline executives (and passengers) are bracing themselves for ever-increasing levels of ancillary revenue activity.

### **About the survey**

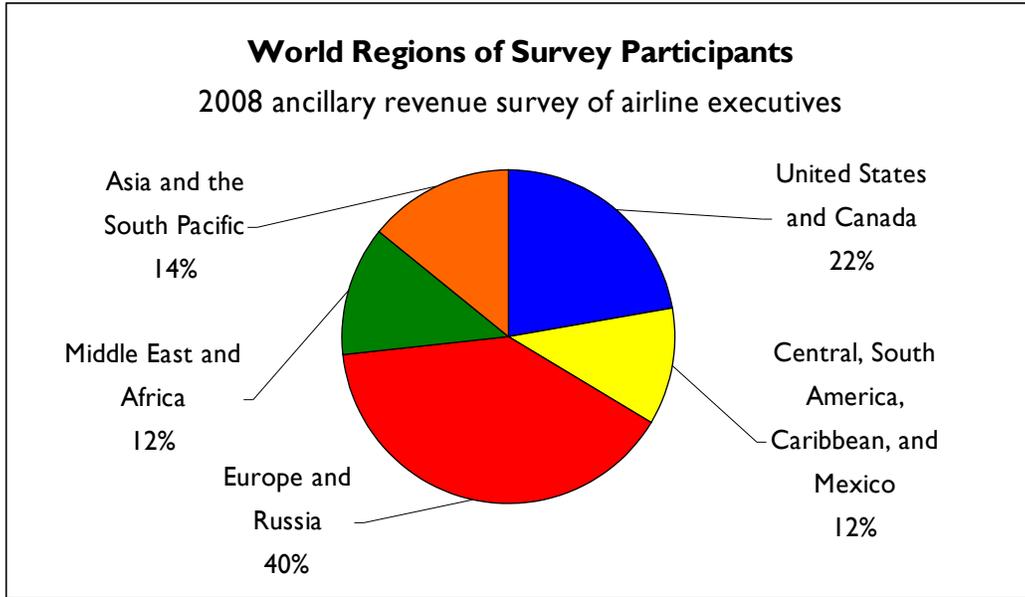
The 2008 survey was conducted online from June - August 2008. IdeaWorks and Terrapinn solicited participants via email with an offer to receive an advance copy of this report. Geographic distribution was similar to 2007 with good representation from all regions of the world. Survey questions were largely consistent from 2007 with the addition of 10 new a la carte features for airline executives to consider.

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<sup>4</sup> "United Tests Food Choices in Business and Economy" press release issued by United Airlines on August 22, 2008.

<sup>5</sup> "United Airlines to end free meals in coach for international flights" article in the Los Angeles Times dated August 24, 2008.

**Airline Executives Predict More Fees**  
**Page 4**



**Charging for amenities becomes more prevalent**

The first question in the survey provides an excellent year over year barometer of ancillary revenue activity. Respondents indicating an increased level of fees for amenities jumped by 6 percentage points from 2007.

<b>Which best describes current trends regarding charging fees for amenities in the airline industry?</b>	<b>2008 Survey</b>	<b>2007 Survey</b>	<b>Change</b>
Unbundling (charging for amenities) is becoming more prevalent.	69%	63%	+6 points
No clear trend, some airlines include amenities in the price of a ticket; others are charging fees for amenities.	23%	37%	-14 points
Bundling (including free amenities) is becoming more prevalent.	8%	0%	+8 points

Unbundling is the practice of removing amenities from a carrier’s basic transportation product. These amenities become a la carte features that travelers may purchase during the process of making a reservation or checking in for the flight. The results also reveal a 14-point decrease among airline executives who feel there is no clear trend. Surprisingly, the practice of bundling - - the inclusion of amenities in the price of a ticket - - gained support for 2008. This is a curious development, which might be explained by the airline industry’s increased emphasis on premium products for business travelers. For example, the concept of premium economy cabin service gained greater acceptance during 2008.

## Airline Executives Predict More Fees

### Page 5

Every a la carte fee in the 2007 survey showed an increase for 2008. The following ancillary revenue activities registered a greater than 10 point increase:

Survey participants who indicated a fee is charged for the following services provided to customers	2008 Survey*	2007 Survey*	Change
Making a booking via the call center	65%	49%	+16 points
Onboard meals or sandwiches	50%	36%	+14 points
Onboard beverages, cola, juice	42%	25%	+17 points
Onboard light snack such as pretzels	40%	24%	+16 points
Pre-assigned premium seats, exit rows	38%	20%	+18 points
Online payment with a credit card	36%	19%	+17 points
Pre-assigned seats	29%	11%	+18 points
1st piece of checked baggage	21%	8%	+13 points

\* Other responses indicated were a) service was provided without a fee, or b) was not offered by the carrier.

Survey results for call center bookings leapt from 49% to 65%, and the sale of meals and sandwiches went from 36% to 50%. All of the increases are significant and the above activities represent the primary tools in a carrier's ancillary revenue toolbox. Certain activities are more prevalent in particular regions of the world.

For example, the sale of soft drinks and pretzels is just beginning in the United States. US Airways recently captured unwanted media attention when it announced a \$2 charge for non-alcoholic beverages in domestic economy class effective August 2008.<sup>6</sup> The change is part of new ancillary revenue initiatives that US Airways estimates will generate \$300 to \$400 million annually, which included the introduction of a \$15 first-checked-bag fee within North and Central America.

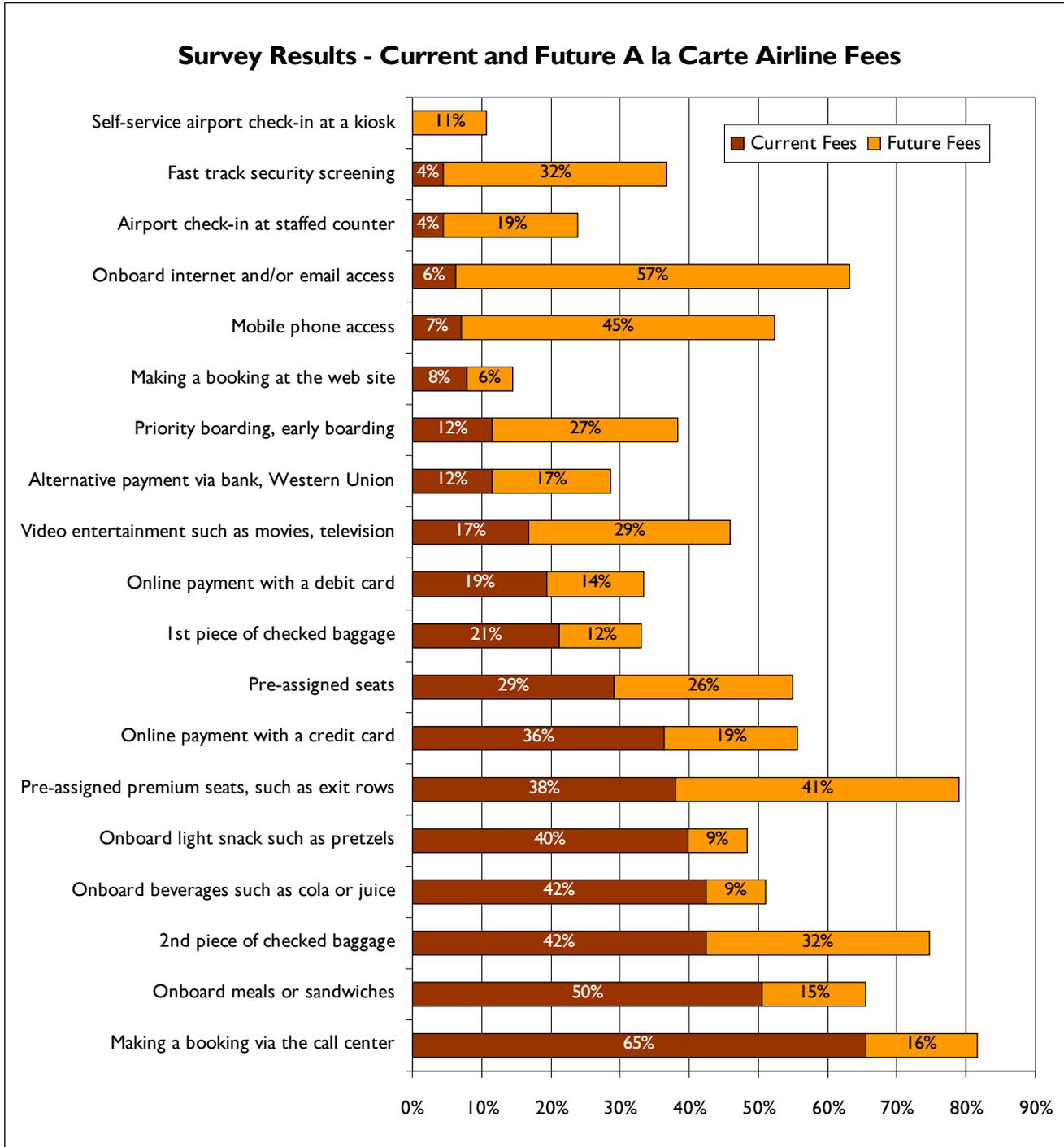
Europe's history of low cost carriers has made it a leader for ancillary revenue activity. Market leaders Ryanair and easyJet charge fees for checked baggage, early boarding, onboard drinks and snacks, and payment for tickets by credit card. These two European low cost airlines also appear to share an unofficial status as ancillary revenue incubators. Success at Ryanair and easyJet seems to validate a concept for industry-wide adoption. Within the United States, major airlines are only too happy to allow a competitor to test a fee on consumers before the majority of carriers copy the new charge.

<sup>6</sup> "US Airways Accelerates Business Model Transformation" press release from US Airways dated June 12, 2008.

**Airline Executives Predict More Fees**  
**Page 6**

**19 a la carte fees were included in the 2008 survey**

The following graph displays the survey results for current fees charged by airlines, and the planned addition of a la carte fees in the future.



## Airline Executives Predict More Fees

### Page 7

It is probably best to begin the analysis of survey results with a description of the a la carte method. IdeaWorks offers the following definition of ancillary revenue:

***Revenue beyond the sale of tickets that is generated by direct sales to passengers, or indirectly as a part of the travel experience.***

***IdeaWorks further defines ancillary revenue using these categories: 1) a la carte features, 2) commission-based products, and 3) frequent flier activities.***

A la carte features represent key items on the ancillary revenue menu and consist of the amenities consumers can add to their air travel experience. IdeaWorks believes the list of items falls into these 3 categories: 1) booking related and seat assignment, 2) airport services and checked baggage, and 3) onboard food and services. The latter can be difficult to categorize, as onboard sales may include commission-based items such as duty-free shopping for which the airline merely earns a commission on the products sold.

### Analyzing the survey results for each category

- **Booking and Seat Assignments.** Activity related to bookings and seat assignments has the highest level of survey response. A la carte fees for pre-assigned seats, call centre bookings, payment by credit card, and other items in the category, averaged a 30% response rate among survey participants. This is not surprising, as these fees can be centrally administered via carrier websites. Online technologies, and vendor supported programs, allow airlines to launch these ancillary revenue activities. A surprising development - - much to the dismay of Visa, MasterCard, and American Express - - is the prevalence of fees associated with credit card payments. Airlines are becoming less reluctant to pass on the cost of credit card merchant fees to the consumer.
- **Onboard Food and Services.** The second biggest category is onboard food and services. The sale of food and beverages, new opportunities related to internet and mobile phone access, and other items, had an overall rate of 27%. Airlines have realized the aircraft cabin can provide an ideal selling environment due to the captive audience. Future opportunities, such as wireless access, will develop slowly as these require aircraft time on the ground and capital investment related to system hardware.
- **Airport Services and Checked Baggage.** Fast paced growth will likely occur in the airport services and checked baggage category. Major carriers in the United States have breached the barrier that required the inclusion of checked baggage as a coach class amenity. Charging for checked baggage, early boarding benefits, staffed counter support, and other items, had an overall survey presence of 14%.

## Airline Executives Predict More Fees

### Page 8

The distinction between the first and second piece of checked baggage points toward the industry's occasionally timid nature. 42% of survey respondents indicate their carriers currently charge for the second piece; the rate for the first piece is far lower at 21%. The incidence for second piece fees jumps to 74% when the current and future responses are combined.

### Ancillary revenue is here to stay

The 2008 survey of airline executives included a new question to determine the importance of ancillary revenue to individual carriers. More than 50% indicated ancillary revenue is very important, with a total response of 82% when combined with the "moderately important" response.

<b>Which best describes the importance placed on ancillary revenue for helping drive profits for your airline?</b>	<b>2008 Survey</b>
Very important; more cost cutting and higher fares are almost impossible to achieve.	53%
Moderately important; it's part of an overall move to cut costs and try to increase fares.	29%
Not very important; the biggest profit benefit will come from more cost cutting and fare increases.	11%
None of the above, or don't care to answer.	7%

The question has been posed on numerous consumer chat boards and in the media - - "Will prices go down if the price of oil drops?" IdeaWorks believes airfares and fuel surcharges are affected by fuel prices. Consumers will expect lower airfares if they are paying less for gasoline for their automobiles. A la carte fees are a more opaque form of pricing; a drop in fuel price might not suggest a lower fee for an early boarding benefit and call centre support.

Airlines should be careful when linking a la carte fees to the increased cost of fuel . . . the correlation might be regretted someday. United Airlines used an eloquent approach when it recently announced a package of ancillary revenue initiatives. "Travel Options by United" positions the a la carte services as allowing travelers to customize the flight experience.<sup>7</sup> Daily airport lounge access, bonus mileage acceleration, economy plus seating, and seven other features, will undoubtedly provide significant revenue for United. The combination of marketing flair and a benefits-focused presentation should help ensure better consumer acceptance.

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<sup>7</sup> Travel Options by United viewed August 25, 2008 at the company website: [united.com/enhancements](http://united.com/enhancements).

## **Airline Executives Predict More Fees**

### **Page 9**

But the effort shouldn't stop with fancy packaging and a press release. IdeaWorks believes the future of the ancillary revenue movement relies upon an effective sales strategy to engage employees through communication and training. The best efforts reward customer contact staff through revenue sharing incentives. At a minimum, employees should understand and embrace the need for fees.

But IdeaWorks also believes the greatest sin is a lack of clarity for consumers. For example, airlines should provide the complete list of fees in an easily found space on the website. Ryanair, for all the consumer critiques it may suffer, is exceptionally clear on the topic of fees. Many of the FAQs at the Ryanair.com direct consumers to an easy-to-understand "Table of Fees" that provides the carrier's a la carte menu. The equivalent information for other airlines is typically sprinkled throughout a carrier's website . . . and very frequently is not offered at all.

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**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. *Special note: Readers of the 2007 survey results report (dated August 17, 2007) may note differences in the 2007 results reported in the table on page 5 of this report. Results in this report reflect the full range of responses (for 2007 and 2008), while the prior report omitted the response in which an airline did not provide the service described in the survey.*

**About IdeaWorks:** IdeaWorks was founded in 1996 as a consulting organization building revenue through innovation in product, partnership and marketing. Its international client list includes the airline, hotel, marine, railroad, and consumer product industries. The firm is a leading expert on creating ancillary revenue opportunities for airlines. IdeaWorks has worked with airlines on ancillary revenue projects in Europe, the United States, and South America. The consulting firm has helped create frequent flier programs and develop co-branded credit cards in the USA, Europe, and South America. Learn more at: [IdeaWorksCompany.com](http://IdeaWorksCompany.com)

**New for Summer 2008:** IdeaWorks presents a fixed-price solution for airlines seeking to build ancillary revenue. This consulting package provides a week of on-site consulting services that supports three primary ancillary revenue areas: 1) commission-based products at the website, 2) travel-related a la carte services, and 3) onboard a la carte features.

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